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Federal Income Taxation of Insurance Trusts: Review and Reassessment

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FEDERAL INCOME TAXATION OF INSURANCE TRUSTS: REVIEW AND REASSESSMENT

ERNEST L. FOLK, III*

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"[In] the great sprawling jellyfish which is Alexandria today * * * the communities still live and communicate * * * [and] the shudders of monetary transactions ripple through them like wind in a wheatfield."

— DURRELL, *BALTHAZAR* 151 (1960).

I. INTRODUCTION*

One of the most flexible tools of estate planning today is the insurance trust.¹ Underlying its deserved popularity are both the convenience to the grantor of thus assuring uninterrupted payments of his insurance premiums, and, more particularly, the facility with which the insurance trust aids the post-mortem disposition of the policy proceeds. At death, the proceeds are, of course, received impressed with a trust. Depending upon the directions in the instrument, the trustee may pay them out at once to the beneficiaries named, usually, in the trust indenture; or, — and here the utility of the insurance trust is especially evident — the trust-impressed proceeds may, in the case of a funded trust, be added to the existing corpus, the income from which has paid the insurance premium. Thus, the estate planner has available a precision tool of many uses, depending upon the desired form and purpose. Moreover, the utility of insurance trusts, like all insurance in estate planning, is enhanced by the relatively

*Portions of this paper were read by Professors Coleman Karesh and Charles H. Randall of the University of South Carolina Law School. Their helpful suggestions are gratefully acknowledged.

1. This paper is confined primarily to insurance trusts in their conventional context of estate planning. The use of business insurance — and particularly the possible employment of the insurance trust in this connection — is briefly commented upon at several places (notes 52 and 99; text at note 139a, *infra*), but it is not extensively developed in this paper. It is intended to discuss aspects of this problem in a later study.

liberal estate tax treatment of insurance proceeds under the Internal Revenue Code.²

The benefits of the insurance trust must, however, be measured against its income tax consequences during the grantor's life, under section 677(a) (3) of the 1954 Internal Revenue Code. That section taxes to the trust's grantor the trust income which is, or may be, used to carry insurance on the grantor's life. To a degree notable even in the intricately worded federal tax statutes, the precise language of this section is of central importance. Its specificity has invited efforts, successful and otherwise, to escape its exact terms and thus take advantage of the potential tax savings which an insurance trust may afford. Grantors of insurance trusts, however, have been subject to personal taxation on insurance trust income, ever since the Revenue Act of 1924 included an embryonic provision on the matter.^{2a} Continuing re-enactments, resulting finally in the language of section 677(a) (3) of the 1954 Code,³ are tacit recognition of the frequency of this type of trust in contemporary estate planning. The case law construing these statutory predecessors of section 677(a) (3) in a variety of fact situations is especially rich, and it remains, for the most part, applicable under the present law,⁴ thus affording needed guidance in view of the sparsity of reported decisions and rulings under 677(a) (3). Finally, although the projected comprehensive revision by Congress of Subchapter J (Estates and Trusts) would amend section 677

2. INT. REV. CODE OF 1954, § 2042.

2a. Section 219(h), 43 Stat. 277.

3. Section 677. Income for Benefit of Grantor.

(a) General Rule. — The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both may be . . .

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under § 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

4. Mertens says that because old § 167 and new § 677 are "generally the same in substance," "it appears safe in most instances to cite the decisions arising under Section 167 as precedents in discussing the present provision." 6 MERTENS, FEDERAL INCOME TAXATION § 37.09 at 35 (1957).

(a) (3), it is clear that, even if enacted, it would not significantly affect the section or its judicial gloss.⁵

The present paper focuses primarily upon the income taxation of insurance trusts. Since it assumes for the most part that estate and gift tax aspects have been analyzed and accepted, and that the trust fits the purpose of the particular estate plan, we shall refer only incidentally to considerations other than income tax consequences. We stress here, as elsewhere, the great importance of considering all relevant factors, both tax and non-tax, in deciding upon the use of the insurance trust in an estate plan, and the fact that income tax savings may be wholly overborne by other considerations. It is, indeed, a paltry accomplishment to save tax money in the short run through a plan which may result in serious harm to a client's long run, non-tax interests.

II. THE NATURE OF THE INSURANCE TRUST

Helpful at the outset is a brief review of certain special characteristics of the insurance trust.⁶ As the name implies, the transfer of some interest in policies of insurance is an indispensable element to any insurance trust. Usually, the interest is that of the grantor-insured who transfers in trust policies on his own life, typically as a part of his personal estate plan. Upon his death, the proceeds of the insurance are paid to the trustee who will treat the funds as the trust instrument provides. Thus, the proceeds may be paid immediately and directly to the beneficiaries, in which case the only discernible advantage of the trust device is the convenience of having the trustee pay the premiums, together with possible tax savings in appropriate situations. On the other hand, a real (though non-tax) advantage of the trust method shows itself if the insurance proceeds on the insured's death, instead of being paid over to the beneficiaries, are designated as the corpus of an ordinary trust. Again, the grantor may entrust policies taken out by him on the life of any other person in whom he has an insurable interest,

5. See notes 95A and 234 *infra* for a brief discussion of the proposed changes in § 677(a) (3).

6. It is generally agreed that § 677(a) (3) and its predecessors apply only to express trusts. "A trust *ex malificio*, a resulting trust, or a constructive trust, are examples of trusts which do not fit into the frame of the statute. A trust, as therein understood, is not only an express trust, but a genuine trust transaction." *Stoddard v. Eaton*, 22 F. 2d 184, 186-87 (D. Conn. 1927).

although such trusts seem to be less frequent, and are, as we shall see, usually prompted by tax considerations. Finally the named beneficiary of an insurance policy may transfer in trust the interest which he has in the insurance policy payable to him, even in jurisdictions which explicitly assert that during the insured's life the beneficiary has no "vested interest" having only a "mere expectancy."⁷ This seeming violation of the doctrine that a trust of an "expectancy" is invalid is, of course, a reflection of the law's tender regard for insurance.

Insurance trusts may be classified as *funded* or *unfunded*. The grantor-insured creates an unfunded trust when he transfers nothing other than the insurance policies on his or another's life. The trustee's role is minimally to hold the policies

7. This typical language appears in *Smith v. Coleman*, 184 Va. 259, 270, 35 S. E. 2d 107, 112 (1945). There is, in fact, a good deal of semantic quibbling in the cases over the proper term to describe the beneficiary's interest. There is no difficulty if the insurance policy is irrevocable, as many early, and some few contemporary policies may be, for then the beneficiary takes a vested interest. See *Central Bank v. Hume*, 128 U. S. 195 at 206 (1888) (dictum); *Hooker v. Sugg*, 102 N. C. 115, 8 S. E. 919 (1889); *Mutual Benefit Life Ins. Co. v. Swett*, 222 Fed. 200, 204 (6th Cir. 1915) (dictum). Clearly this is an appropriate trust res.

Conceptual difficulties appear with the typical policy reserving the insured's right to change the beneficiary. Basically it is a chose in action. In traditional property law parlance, it may be termed a "defeasible, vested interest," *Indiana Nat'l Life Ins. Co. v. McGinnis*, 180 Ind. 9, 22, 101 N. E. 289, 293 (1913), or a "vested right . . . subject to be divested," *Id.* at 24, 101 N. E. at 294, in which case it is a present interest capable of constituting a trust res. See RESTATEMENT, TRUSTS 2d § 84 (1959). A great majority of states, including South Carolina, identify the interest as a "mere expectancy and not a vested right or interest," *Dryman v. Liberty Life Ins. Co.*, 216 S. C. 177, 180, 57 S. E. 2d 163, 166 (1950); *Swygert v. Durham Life Ins. Co.*, 229 S. C. 199, 203, 92 S. E. 2d 478, 480 (1956), or as "only an inchoate, imperfect, and ambulatory right" before the insured's death, *Stepson v. Brand*, 213 Miss. 826, 834, 58 So. 2d 18, 21 (1952); *Swygert v. Durham Life Ins. Co.*, *supra* at 203, 92 S. E. 2d at 480 (an "inchoate right"). Although on this view it may be said that the rights vest only upon the insured's death, *Babb v. Paul Revere Life Ins. Co.*, 224 S. C. 1, 9, 77 S. E. 2d 267, 270 (1953); *Swygert v. Durham Life Ins. Co.*, *supra* at 203-04, 92 S. E. 2d at 481, it is, however, recognized that during the insured's lifetime, the beneficiary is nevertheless "entitled to the protection which the policy gives it, not to be defeated except in the contract method," with which there must be "at least a substantial compliance." *Dryman v. Liberty Life Ins. Co.*, *supra* at 180, 57 S. E. 2d at 166. Since arguably an interest dubbed a "mere expectancy" or "inchoate" is equivalent to a prospective heir's or devisee's interest which is not assignable or subject to trust, 1 SCOTT, TRUSTS, § 83.1, at n. 2 (2d ed. 1956); RESTATEMENT, TRUSTS 2d § 86 (1959), the beneficiary has nothing which is properly a trust res. Despite the varying verbal descriptions of the beneficiary's interest before the insured's death, courts have consistently sustained a beneficiary's transfer in trust of that interest, although recognizing that it could be defeated by the insured's reserved power to change the beneficiary. See generally 1 SCOTT, TRUSTS § 84.1 (2d ed. 1956); Note, 42 VA. L. REV. 256 at 264-67 (1956); RESTATEMENT, TRUSTS 2d § 84, comment (b) (1959).

until the insured's death, and upon that event to collect the proceeds and use them for the purposes designated by the insured. During the insured's life, premiums are paid by the insured (either directly or through the trustee to whom he furnishes the money). A funded trust is established when the insured transfers, in addition to the policies, the necessary capital to enable the trustee to pay the premiums on the policies. The trustee's duties more nearly resemble those of the typical active trustee, since the capital is ordinarily in the form of securities, and the trustee usually has much more extensive duties to perform. Needless to say, in a multi-party group, *e.g.*, family or partnership, any number of trusts may be established in a coordinated way; and, in fact, we shall see the extent to which such an integrated system of trusts may reduce income taxes.

Insurance trusts, especially those which are funded, may display most of the varieties found in any other kind of trust. Particularly characteristic is the grantor's reservation of broad powers both under the policies and under the insurance trust itself, an aspect which has furnished fertile ground for non-tax litigation challenging the trusts as testamentary in character. Wholly apart from any trust, an insured may retain under his life insurance policies the following rights, any or all of which may be exercised without the consent of the beneficiary:

1. To change the beneficiary of the policy, or add new beneficiaries, thereby destroying or diluting the present beneficiary's interest without his consent;
2. To surrender the policy to the insurer and recover the premiums already paid;
3. To borrow money from the insurer, pledging the policy as collateral;
4. To pledge the policy as collateral in securing loans from other lending institutions;
5. To elect among optional modes of paying the benefits.

Not infrequently, when the insured creates an insurance trust of his policies, he will retain some or all of these powers under the policies and, in addition, may reserve power to revoke or amend the trust and to withdraw policies from the trust. The totality of these reserved powers represents an extreme instance of a grantor's retained control over

the corpus.⁸ Actually, such broadly reserved powers are rarely necessary to implement the grantor's purpose; the trust often takes such a form out of ignorance or inattention, and it may have serious consequences, both tax and non-tax.

Apart from the tax results of such retained control, the trust may run the risk of being declared testamentary in character under state law, and therefore void for want of the formalities needed to validate a testamentary disposition. Initially noted is the fact that life insurance, of itself, "is to a large extent testamentary in character in that it contemplates the transfer of property upon the death of the insured in accordance with the directions of the decedent."⁹ Nevertheless, courts have unanimously held that the validity of life insurance does not depend on testamentary formalities. This is true despite the retention by the insured of the maximum number of powers and rights under the policies. The various formalistic theories supporting this result¹⁰ all ultimately rest upon and are justified by the fact that public policy, favoring widespread use of insurance, would be defeated by requiring observance of the ritual of the wills' acts.

Like considerations apply when the insured, in order to facilitate the management and disposition of his insurance, superimposes a trust upon the policies. In view of the powers widely retained under insurance policies themselves, the fact that one also decides to keep broad powers under the trust (both as to the trust's corpus and the beneficiaries), should not make the transaction any more testamentary than it would otherwise be. Accordingly, most courts have sustained insurance trusts characterized by unusually broad retained pow-

8. Such extensive powers were in fact reserved in the trust sustained in *Gurnett v. Mutual Life Ins. Co.*, 356 Ill. 612, 191 N. E. 250 (1934) (unfunded trust).

9. *Fidelity & Columbia Trust Co. v. Glenn*, 39 F. Supp. 822, 825 (W. D. Ky. 1941). See also *Beck v. West Coast Life Ins. Co.*, 38 Cal. 2d 643, 646, 241 P. 2d 544, 546 (1952). See generally Note, 42 VA. L. REV. 256 at 261-264 (1956).

10. Thus, it can be said that, unlike the interest taken under a will, the insurance beneficiary interest vests immediately although subject to defeasance, compare *Hooker v. Sugg*, 102 N. C. 115, 120, 8 S. E. 919, 921 (1889), and that the insured's death merely terminates the defeasibility aspect and gives possession of the funds to the beneficiary. It may also be said as some courts have stated, *e.g.*, *Sigal v. Hartford Nat'l Bank & Trust Co.*, 119 Conn. 570, 575, 177 Atl. 743, 744 (1935), that the insured does not during his life, own the policy proceeds, and because the policy "does not operate upon any property of the insured owned by him at death", *ibid.*, it cannot be, strictly speaking, testamentary.

ers in the grantor,¹¹ although a few contrary cases warn of a lurking danger that the trust might be deemed testamentary and fail for want of formalities.¹²

III. DEVELOPMENT OF STATUTES TAXING INSURANCE TRUST INCOME TO THE GRANTOR

In the absence of any provision in the Internal Revenue Code, such as section 677(a)(3) or its predecessors, the insurance trust medium would permit substantial tax savings for the individual who established such a trust. If, for example, a high bracket taxpayer directly pays premiums on his life insurance with dividends of \$50,000 which he receives from stocks having a current market value of \$1,000,000, he effects no tax saving: the dividends are taxed to him personally at his high tax rates, and no deduction is available for the premiums paid. In contrast, if the tax laws were unreservedly to recognize a funded insurance trust as a separate taxable entity, a transfer of securities and policies to such a trust would be in order, since the \$50,000 dividends would not be taxed to the grantor at his high personal rates, but to the trust at significantly lower rates. Thus, in principle,

11. See *Gurnett v. Mutual Life Ins. Co.*, 356 Ill. 612, 191 N. E. 250 (1934) and *Bullen v. Safe Deposits and Trust Co.*, 177 Md. 271, 9 A. 2d 581 (1939).

12. The factors which may come into play here are summarized and analyzed in detail in *Insurance Trusts as Testamentary Transfers: The Bickers Case*, 42 VA. L. REV. 256 at 273-289 (1956). They include, (1) the reservation of powers by the grantor (as in the *Gurnett* case, *supra* at notes 7, 10), (2) the determination whether or not a "present interest" has been transferred, (3) the scope of the trustee's duties, i.e. whether the trust is active or dry, (4) the dependence, in various degrees and respects, of the trust upon the will, and (5) the aspect of fraud upon a spouse. Too great an aggregation of these factors, and particularly integration of the trust with a will, may override judicial solicitude for insurance and cause defeat of the insurance trust as testamentary. The paramount recent instance of such a situation is *Bickers v. Shenandoah Valley Nat'l Bank*, 197 Va. 145, 88 S. E. 2d 889 (1955), *rehearing denied*, 197 Va. 732, 90 S. E. 2d 865 (1956) in which a sharply divided Virginia court struck down an insurance trust as testamentary and void for want of wills formalities. Because of the "doubt" which the prior opinion cast upon the "validity of revocable trusts", 197 Va. at 732, 90 S. E. 2d at 83, the majority subsequently clarified the prior decision to stress that "[t]he infirmity in the trust is not due to its revocability, . . . [but] to the maker's expressed intent and dominant purpose that it not be effective until his death and then only if he left a valid will." *Id.* at 733, 90 S. E. 2d at 86. The minority, however, adhered to its dissent. Professor Scott regards the decision as of dubious soundness. 1 SCOTT, TRUSTS § 57.3, at n. 23a (1959 Supp.). Nearly contrary to the *Bickers* decision is a much sounder Maryland case, *Bullen v. Safe Deposit & Trust Co.*, 177 Md. 271, 9 A. 2d 581 (1939). Also on the non-testamentary character of insurance, see *Bynum v. Prudential Ins. Co.*, 77 F. Supp. 56, 62 (E. D. S. C. 1948). See also Annot., 53 A. L. R. 2d 1112 (1957).

wherever the trust's tax rates would be less than the individual's, an insurance trust would likely permit tax savings.¹³ It is apparent, then, that tax savings are effected not because trusts possess a more favorable tax status or from any greater likelihood of capital gain treatment from transactions, but simply from the allocation of a person's income among other taxable entities, no one of which approaches the taxpayer's top bracket if all of his income were attributed to him personally. Indeed, it was "[b]y the creation of trusts" such as these that "incomes had been so divided and subdivided as to withdraw from the Government the benefit of the graduated taxes and surtaxes applicable to income when concentrated in a single ownership."¹⁴

A. Statutory Provisions—1924 to Date

Congress in the 1924 Revenue Act taxed trust grantors for the first time upon the income trusts funded to purchase insurance on their lives.¹⁵ In a statement which articulates the major purpose of all of the successive enactments relating to grantor taxation of insurance trust income used for the grantor's insurance policies, the House Committee, speaking of section 219(h), observed that

Trusts have been used to evade taxes by means of provisions allowing the distribution of the income to the grantor *or its use for his benefit*. The purpose of the bill is to stop this evasion.¹⁶ (Emphasis added).

This early version taxed to the grantor "any part of the income of a trust [which] is or may be applied to" insurance¹⁷

13. The transfer is subject to gift taxes (see text at notes 102-105 *infra*), and in certain circumstances the securities used to fund the trust may be included in the grantor's estate for federal estate tax purposes (see text at note 109 *infra*).

14. *Burnet v. Wells*, 289 U. S. 670, 675 (1933).

15. That the insurance trust tax provisions of § 677(a)(3) and its predecessors apply as a practical matter only to funded trusts is apparent from the statutory language, which treats the grantor as the owner of any portion of a trust "whose income" is or may be used for the grantor's insurance policies. Obviously only a funded trust could yield "income," and the statutory wording shows that it must be the trust's own "income," since an unfunded trust, as we have already noted *supra* at p. 145, is essentially a dry trust of insurance policies whose premiums are paid outside the unfunded insurance trust, *e.g.* by the grantor or other individual, or by income from another trust.

16. H. R. REP. No. 179, 68th Cong., 1st Sess. 21 (1924). See also S. REP. No. 398, 68th Cong., 1st Sess. 25 (1924).

17. "... [W]here any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor [except irrevocable trusts for charitable purposes] ...

on the grantor's life. Later, section 167 (a) (3) of the Revenue Act of 1932 limited the grantor's liability for income taxes to that income which "is, or in the discretion of the grantor or of any person not having a substantially adverse interest in the disposition of such part of the income, may be applied" to premiums on the grantor's life insurance. Thus, under the 1932 provision—which appears in identical form in the 1939 Code and, with some slight language changes, in the 1954 Code—the grantor would be immunized from tax liability if a "substantially adverse interest" could block application of the trust income to keep up insurance on the grantor's life.¹⁸ In the 1954 Code provision, "any adverse party" performs the same role as the "substantially adverse interest" of the 1939 Code. The 1954 Code section is also rephrased by declaring that the grantor shall "be treated as the owner of any portion of a trust" (wholly apart from his ownership by virtue of a general power to control "beneficial enjoyment" of income or corpus)¹⁹ whenever the trust income, without an adverse party's consent, may be used for the grantor's insurance. The development and refinement of the basic idea, somewhat crudely enunciated for the first time in the Revenue Act of 1926, is all "[o]f a piece" with the progressive endeavor by the Congress and the courts to bring about a correspondence between the legal concept of ownership and the economic realities of enjoyment or fruition."²⁰

In *Burnet v. Wells*,²¹ a sharply divided Supreme Court sustained the constitutionality of taxing to the grantor of the trust, income irrevocably dedicated by trust to policies of insurance on the grantor's life payable only to third-party

such part of the income of the trust shall be included in computing the net income of the grantor." Revenue Act of 1924, § 219(h), 43 Stat. 277. The identical provision appears in the Revenue Act of 1926, § 219(h), 44 Stat. 34; and in the Revenue Act of 1928, § 167, 45 Stat. 840.

18. Section 167(a) (3) of the Revenue Act of 1932, 47 Stat. 221 adopted language which appeared also in the Revenue Act of 1934, § 167(a) (3), 48 Stat. 729; Revenue Act of 1936, § 167(a) (3), 47 Stat. 221; Revenue Act of 1938, § 167(a) (3), 52 Stat. 519, and in that form became § 167(a) (3) of the Internal Revenue Code of 1939, 53 Stat. 68. It provides that:

Where any part of the income of a trust . . .

(3) is, or in the discretion of the grantor or of any person not having a substantially adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor . . . [except for insurance payable to charities]; then such part of the income of the trust shall be included in computing the net income of grantor.

19. See INT. REV. CODE OF 1954, § 674.

20. *Burnet v. Wells*, 289 U. S. at 677 (1933).

21. 289 U. S. 670 (1933).

beneficiaries after the grantor's death. Despite its irrevocability, the Court stressed the insured-grantor's "rights and interests" in the continued existence and functioning of the trust,²² and the fact that income so used for insurance trusts is realistically used "for his benefit in such a sense and to such a degree that there is nothing arbitrary or tyrannical in taxing it as his."²³ Finally, the very creation of the trust involves the grantor's continuing exercise of a "power to direct the application of the income along predetermined channels,"²⁴ thus impressing upon the trust income "from first to last . . . the will of the grantor announced at the beginning."²⁵

These principles appear never to have been pushed to the limits of their validity, chiefly because the statutory language does not attempt to go as far as the *Burnet v. Wells* dicta would justify and also because what statutory authority there is has been given a rather restricted scope by the courts. Confining ourselves to the field of insurance trusts, and recognizing that even the scope of Supreme Court dicta may be limited by the boundaries of holding and fact, the *Burnet v. Wells* statement could have very broad application. Thus, if the test is as broad as this case indicates, it is arguable that Congress could constitutionally attribute personally to almost every insurance trust grantor the income of the trust, since the grantor, even when the trust transfer is irrevocable (as it was in the *Wells* case), has impressed on the trust income "from first to last" his "will . . . announced at the beginning," thereby "direct[ing] the application of the income along predetermined channels." The use of insurance on the life of another person—not presently covered by the statutory wording—comes within this test, since again the grantor's "will" is determinative, and there is, unquestionably, the use of trust income for the grantor's "benefit," even though that "benefit" may more directly inure to others. The question would seemingly become whether the "benefit" to the grantor whose "will . . . [was] announced at the beginning" of the trust was so slight or remote that it would be "arbitrary or tyrannical" to attribute the income to him personally. A very broad reading of the constitutional test is also in order

22. *Id.* at 679-80.

23. *Id.* at 680-81.

24. *Id.* at 681-82.

25. *Id.* at 682.

if, as the Congressional reports point out, the statute is intended to reach income distributed by the trust "to the grantor or its use for his benefit."²⁶ Of course, it is one thing to attempt to indicate, as we have here, the outer limits of Congressional power to attribute insurance trust income to its grantor; it is another thing for Congress to reach, as its enactments never have, the farthest boundaries of that power.

The only other Supreme Court decision on insurance trust income taxation is *DuPont v. Commissioner*,²⁷ decided the same day as *Burnet v. Wells*. It involved several three-year irrevocable trusts subject to indefinite extensions at the grantor's option, and the Court, following *Wells*, held the income properly attributed to the grantor. Even the justices who dissented from the *Wells* holding on the ground that the grantor's power there had wholly ended concurred in *DuPont* with the majority's sound assertion that "[o]ne who retains for himself so many of the attributes of ownership is not the victim of despotic power when for the purpose of taxation he is treated as owner altogether."²⁸ These two cases, both in their holdings and well considered dicta, furnish a solid foundation for developments in taxing insurance trust income to the trust's grantor.²⁹

B. Legislative History of the 1954 Code Provision

Before the enactment of the 1954 Code, the American Law Institute drafted a model statute,³⁰ section X-852(a) of which taxed the grantor on any trust income which, without the consent of an adverse party, was or could be applied to the payment of premiums on the grantor's life insurance. This recommended version was regarded as a restatement of existing law, its exact language eventually becoming section 677(a).³¹

26. See note 16, *supra*.

27. 289 U. S. 685 (1933).

28. *Id.* at 689.

29. Other cases taxing the grantor personally on trust income used on his own premiums include *Rieck v. Commissioner*, 118 F. 2d 110, 112 (3d Cir. 1941), *aff'd* 41 B. T. A. 457 (1940); *George Beggs*, 4 T. C. 1053, 1063-64 (1945); *Frank D. Yuengling*, 27 B. T. A. 782 (1933), *aff'd on this point*, 69 F. 2d 971, 972 (3d Cir. 1934). See also *Burnet v. Wells*, *supra* note 20 at the Board of Tax Appeals Level, *Frederick B. Wells*, 19 B. T. A. 1213 (1933).

30. References are to the A. L. I. Draft of February, 1954.

31. Except for § X-852(a) (4) which was not incorporated in the 1954 Code provisions.

The Institute also recommended a clause which would exempt the grantor from taxation resulting solely from the fact that the trustee had an unexercised power to apply trust income to the grantor's life insurance, if the trustee was independent and if the grantor retained none of the incidents of ownership of the policies.³² If, however, the trust income were in fact used to pay premiums during any year, such income would be taxed to the grantor. This provision was designed as a companion to the section exempting income which could be, but was not during the taxable year, applied to the support of persons whom the grantor was legally obligated to support.³³ Congress adopted the support provision, but it did not enact the Institute's proposed clause exempting the grantor from tax on the existence of an unexercised power to use trust income for the payment of the premiums, despite the urgings of the American Bar Association.³⁴

Section 677(a) (3) had an exceptionally uneventful transit through Congress, starting and completing the legislative process with virtually identical wording throughout. Thus, legislative history discloses no design on the part of Congress to change the meaning of the section; and, indeed, we may infer generally that the Congressional purpose was to leave the provision intact. In its "detailed discussion of the technical provisions of the bill," the House Committee merely observed that

Section 677 [of the House bill] corresponds to section 167 of existing law under which income is taxed to

32. 2 A. L. I. Draft § 852(b) (2): "Income of a trust shall not be treated as distributed or accumulated for distribution to the grantor merely because the income . . . (2) may be applied or distributed, in the discretion of a trustee or trustees, no more than half of whom are related or subordinate parties and no one of whom is the grantor or his spouse living with the grantor, without the approval or consent of any other person, to the payment of premiums upon policies of insurance on the life of the grantor, none of the incidents of ownership of which are possessed by the grantor, except to the extent that the income is so applied or distributed."

33. See the present provision in INT. REV. CODE OF 1954, § 677(b).

34. Senate Hearings 449 (1954). Even where a regulatory agency has unsuccessfully sought from Congress a "clarifying amendment" to a statute of uncertain scope, Congressional inaction has been found "without significance" to the interpretation of the unamended statute. *Black v. Magnolia Liquor Co.*, 355 U. S. 24, 26-27 (1957) (Congress requested to amend statute because of agency's "doubt" as to its application to a particular practice; unamended statute nevertheless held applicable to the disputed practice). A fortiori, inaction in response to the urgings of a non-governmental organization is "without significance."

the grantor by reason³⁵ of a power to vest the income in him or to apply it to his benefit.

The Senate Committee similarly noted that the proposed version "corresponds to section 677 of the House bill" and to existing law under section 167(a)(3).³⁶ Both houses added a new provision that section 677(a)—including the insurance trust subsection—should not apply whenever there is reserved a power to affect beneficial enjoyment, if that power can be exercised only after ten years from the transfer. Following the expiration of that period, the grantor must release the power if he is to avoid taxation to him personally of income of a trust subject to such power. With the acceptance of this amendment by the conference committee,³⁷ section 677 was enacted in the present form.

Thus, looking to the plain language of the statute, it is apparent that there are no major changes from prior law. The wording of the section is now somewhat more complex, although more precise, than section 167(a)(3). The new clause precluding grantor taxation if the power cannot be exercised for ten years, does no more than integrate section 677 with the ten-year period governing trusts with reversionary interests (section 673), and parallels those dealing with powers to revoke (section 676) and to control beneficial enjoyment (section 674(b)(2)). The sparse committee discussion of section 677 includes no comments, approving or disapproving, upon the rich fund of cases construing the section's predecessors in a variety of fact situations. However, as we shall see, there is reason to believe that section 677 somewhat alters the impact of decisions in the area *prima facie* subject to the income tax provisions, i.e., trusts which may use trust income to pay premiums on the grantor's life insurance, but do not do so during the tax year.³⁸ The more interesting case law, involving trusts established by the grantor to support insurance on the life of another, seems unaffected, despite the opportunities which this procedure affords for large tax saving. Finally, we shall examine the possible application to insurance trusts of other Code sections, notably those

35. H. R. REP. NO. 1337, 83d Cong., 2d Sess. A-217 (1954); U. S. CODE CONG. & ADM. 4356-57 (1954).

36. S. REP. NO. 1622, 83d Cong., 2d Sess. 371 (1954); U. S. CODE CONG. & AD. NEWS 5012 (1954).

37. See the Conference Report: H. R. REP. NO. 2543, 83d Cong., 2d Sess. (1954); U. S. CODE CONG. & AD. NEWS 5317-18 (1954).

38. See generally Part IV (E) *infra*.

codifying the case law, and regulations which grew out of the Supreme Court's foundation decision in *Helvering v. Clifford*.³⁹

IV. TRUSTS OF INSURANCE ON THE LIFE OF THE GRANTOR

Before analyzing section 677(a)(3) as applied to trusts funded by the grantor to carry his life insurance, it is appropriate to observe the precise way in which the section seeks to achieve its policy objective. First of all, an insured obviously receives no deduction for the amount of money he pays for life insurance premiums. Similarly, even if grantors of insurance trusts were wholly immune from personal taxation upon trust income applied to their life insurance premiums, they, too, would not have the equivalent of a *deduction*. Their advantage would be merely the tax saving incident to income splitting, and that is ordinarily less than the saving resulting from a deduction. The question is whether the law should permit a tax subsidy for the insurance trust method of meeting life insurance premium obligations, while not making it available in other situations. Stated this way, the answer is obviously no. The fact that all elements of control or ownership with respect to the trust have been disavowed does not alter the fact that the grantor's life insurance is maintained, in this case indirectly, by the trustee rather than directly by the individual. The substance of the situation is no different since, in any event, an insured acquires the same benefit for a comparable economic detriment (the expense of insurance payments) whether he has funded a trust (parting with the estimated capitalized value of the premiums) or paid them year by year from his own pocket. In neither situation is there sufficient economic difference to warrant what would be, in effect, a special advantage for the insurance trust method of meeting the obligation.⁴⁰

39. 309 U. S. 331 (1940).

40. This undeniable fact gives added support to the suggestion made earlier (see text at notes 21-26 *supra*) that the *Burnet v. Wells* dictum warrants a very broad power, constitutionally speaking, for Congress to attribute to insurance trust grantors the trust income used for insurance, whether on their own or another's life. The tax law should achieve equal treatment, especially where there is no difference of substance between two methods of doing the same thing, as is the case taxwise with insurance whether in or out of trust. Of course, *Burnet v. Wells* contemplates some relation between the grantor and trust adumbrated in terms of "benefit" to the grantor or imposing at the outset his "will" on the course of the trust. See text at notes 19-26 *supra*. Therefore, identity of economic effect, as between insurance in or out of trust, seemingly would not be

That the statutory objective is the elimination of an unjustified tax advantage related only to form and not reflecting any economic or other tax related differences is evident from a comparison of two cases antedating the 1954 Code provision. *Albert E. Pillsbury*⁴¹ represented an unsuccessful effort to secure the equivalent of a deduction of premiums paid through an insurance trust. There, the grantor funded an irrevocable trust with his own \$150,000 note the 6% interest on which was estimated as sufficient to pay the annual premiums on his life insurance. With judicial approval, the Commissioner taxed back to the grantor personally the income so used by the trust, although allowing him a deduction for the interest paid on the note.⁴² Unless the trust income used on his insurance is taxed back to the grantor personally, he would be able "through the medium of a trust to have insurance premiums allowed as a deduction from gross income when such deductions could not be allowed if the premiums have been paid directly by [the taxpayer] himself."⁴³ That is to say, using the *Pillsbury* facts, that the \$9,000 item originally included in the grantor's income would have been wholly washed out by the \$9,000 deduction allowance, in contrast to a non-trust insured whose \$9,000 would be included in his income without being offset by a deduction for the \$9,000 directly paid on his premiums. For like reasons, it was also necessary, for equitable administration of the law, to allow the interest deduction to the grantor. For without this deduction he would have been taxed on \$18,000 of income, in contrast to the non-trust insured who would have been taxed only on \$9,000.

The sound rule in *Pillsbury* was equally soundly distinguished in *Percy M. Chandler*⁴⁴ some ten years later. There a funded trust directed the trustee to keep up premiums on the grantor's insurance policies through (1) dividends on mutual policies, (2) contributions from the grantor, and (3) trust income, in that order. The Board of Tax Appeals ruled that the grantor's contributions, although actually expended by the trust on the grantor's life insurance, could not be taxed to him since this would obviously involve un-

of itself enough to support a statute unqualifiedly taxing to the grantor the income of any insurance trust created by him.

41. 19 B. T. A. 1229 (1930), *aff'd*, 67 F. 2d 151 (D. C. Cir. 1933).

42. *Pillsbury v. Burnet*, 67 F. 2d at 151 (D. C. Cir. 1933).

43. *Alfred E. Pillsbury*, 19 B. T. A. at 1232-33.

44. 41 B. T. A. 165, 177 (1940), *aff'd*, 119 F. 2d 623 (1941).

warranted double taxation. *Pillsbury* was distinguished on the ground that the interest paid by the grantor there was deductible, while the grantor's contributions in *Chandler* were not. The result, then, of these two cases is to neutralize any advantage (or disadvantage) of paying the grantor's own insurance premiums through insurance trusts, thereby placing that method and the direct payment of premiums on the same basis taxwise. The continued soundness of the decisions, expressing as they do a permanent statutory objective, seems unquestionable.

Section 677(a)(3), as did its predecessors, seeks to achieve this objective apparently by subjecting the grantor to personal taxation whenever income from a trust is or may be applied to the upkeep of insurance policies on the grantor's life. Certainly, the fact that the grantor has renounced all indicia of control over both the policies and the trust will not of itself prevent taxation to him if the policies are on his own life and the trust income has been or may be applied to them. The cases establish this beyond question.⁴⁵ Indeed, section 677(a) expressly treats the grantor as owner of the trust "whether or not he is treated as such owner under section 674." That section generally provides for treating the grantor as owner of any trust where he retains power to control "beneficial enjoyment" of the trust and then spells out various exceptions.

The cumulative effect of years of judicial construction of section 677(a)(3) and its predecessors is to give it considerably less than the maximum scope which the words of the statute would reasonably support, and to a considerable degree, the cases favor taxpayers. Apart from the fact that the statutory language implies an exemption for trusts of insurance on the life of one other than the grantor, the cases construing the statute in relation to the trust grantor's own policies still leave areas where thoughtful drafting may avoid the seemingly explicit mandate of section 677(a)(3). It is at least questionable whether this should be so in the case

45. *Connor v. Gagne*, 42 F. Supp. 231 (D. N. H. 1941) (trust income applied to grantor's life insurance premiums held taxable to grantor although the trust was irrevocable and grantor had renounced rights under his policies; however, he retained power to change beneficiaries named in the trust indenture); *Frederick B. Wells*, 19 B. T. A. 1213, 1226 (1933) (it is "immaterial whether the trusts created by petitioner were revocable or irrevocable"); *Alfred E. Pillsbury*, 19 B. T. A. 1229 (1930), *aff'd*, 67 F. 2d 151 (D. C. Cir. 1933).

of a statute which is obviously intended to equalize the tax position of two methods of reaching the same result in regard to insurance premium payments.

A. Policies Subject to Section 677(a)(3) Taxation

It is, of course, evident from section 677(a)(3) that it applies only to life insurance,⁴⁶ and then only to "policies of insurance on the life of the grantor" of the trust. Thus, policies on the lives of persons other than the grantor are not within the statutory language, so that, at least presumptively, the grantor will not be subject to tax upon the income used to pay premiums on such policies.⁴⁷ Section 677 also specifically exempts from its coverage policies "irrevocably payable" for a charitable purpose, as defined in section 170(c).⁴⁸

The statute clearly embraces every variant of an insurance policy which can fairly be said to be "on the life of the grantor." Although almost all of the cases arising under section 677(a)(3) involve straight life policies, the statutory language is broad enough to include endowment policies as well, since they, too, are "on the life of the grantor." This point was settled some years ago by *Heffelfinger v. Commissioner*,⁴⁹ and since that time there have been no cases raising any issue as to types of policies covered by the section. In *Heffelfinger*, the grantor had placed in an irrevocable funded trust for a named beneficiary a ten-year endowment policy with a face value of \$100,000 retaining no rights under the trust or policy. In sustaining the grantor's taxability under the Revenue Acts of 1924, 1926 and 1928, the circuit court of appeals noted that the statutes "make no distinction between endowment policies and ordinary straight life policies" nor "between that part of the premium which equals the cost of

46. Since § 677(a)(3) concerns only life insurance, it is inapplicable to a trust to pay premiums on various other types of insurance such as fire, accident, automobile, health, and the like, although any tax savings potentialities would be doubtful on other grounds.

47. See Part V *infra*.

48. An interesting speculative possibility of taking advantage of the charitable purpose exemption in § 677(a)(3) is presented by these facts: The taxpayer establishes a funded trust of policies on his life "irrevocably payable" to a charity, thereby avoiding tax on the income applied to premiums. Subsequently he obtains from the charity, for a present cash consideration, a waiver of their vested rights under policies and trust, thereby recovering the policies and changing the beneficiary. Unless by that time the insurance had been paid up — as it might well be — the grantor would thereafter be subject to tax only upon the remaining premiums.

49. 87 F. 2d 991 (8th Cir.), *cert. denied*, 302 U. S. 690 (1937).

protection upon the life of the grantor, and the excess over that amount which may represent the investment feature of the policy.”⁵⁰ This indisputably sound holding and its result and reasoning are equally applicable under the 1954 Code’s like provision.

*B. Transactions Involving Insurance Trusts Subject to
Section 677(a)(3)*

Since the statute does not qualify its declaration that the grantor is “the owner of any portion of a trust” whose income “is, or . . . may be” used to pay premiums on the grantor’s life insurance, it covers every type of transaction falling within the statutory wording, and does not turn on the transaction’s purpose. Although insurance trusts ordinarily function as a part of an estate plan, they may also be an integral part of straight business transactions as well, especially since insurance is often taken out or required in connection with a loan. Thus, in *George W. Vreeland*,⁵¹ decided under the 1939 Code, the taxpayer, who had borrowed a large sum from a bank, placed in a funded trust an insurance policy on his life which the bank had required him to take out as a condition to making the loan. The Tax Court held that the trust income actually applied over a several year period to keep up the policies was to be taxed to the grantor. The trustee, it was held, had no adverse interest. Because it is squarely within the statute, the same result doubtlessly would have followed even if there had been clear testimony that on repayment of the loan, the insurance would be canceled, and that its objective was as much a condition of obtaining the loan as paying interest or furnishing a mortgage.

This apparently little-noticed decision is important for two reasons: (1) The use of life insurance in connection with lending arrangements has greatly increased in recent years,^{51a}

50. *Id.* at 993. Constitutional contentions were disposed of in reliance upon *Burnet v. Wells*, 289 U. S. 670 (1933), and *duPont v. Commissioner*, 289 U. S. 685 (1933). See the discussion at notes 20-29 *supra*.

51. 16 T. C. 1041, at 1046-48 (1951).

51a. At the beginning of 1961, some \$30 billion in credit and loan value was insured under \$43.5 million credit life policies and group certificates. The Institute of Life Insurance regards this as a “major stabilizing factor” in the large consumer debt structure. In 1960 approximately \$125,000,000 was paid out on such claims, and for the past five years the figure is more than \$500,000,000. Indeed, such is the growth of the business that already 18 States have enacted substantially identical laws, based on a model law proposed by the National Association of Insurance Commissioners. *N. Y. Times*, Jan. 8, 1961, § 3, p. 1, col. 2.

and the *Vreeland* case squarely holds section 677(a)(3) applicable in such circumstances where a trust is used;⁵² (2) Generally, it highlights the often overlooked fact that section 677(a)(3), usually considered as applying only to estate plans and intra-family arrangements, also governs strictly business transactions as well. Thus, with the increasing use of business insurance, especially in the closely-held corporation, a new area for use of insurance trusts is beginning to open up, and, if *Vreeland's* analysis holds, section 677(a)(3) will apply here as well.

52. For example, such a trust might prove useful in planning a sell-and-purchase agreement in a partnership, designed to avoid dislocation of business operations incident to the dissolution of a partnership upon the death of a partner. Thus the funds for the purchase of the deceased's partners share could readily be supplied if each partner's life was insured by the other partners, and the policies placed in a trust. The premiums could be maintained by partners' payments to the trustee. The cost of such an insurance program would not be burdensome, since, in a ten-partner firm, each partner would pay 1/9 of the premium cost on the insurance on each of his partner's life; the total premium cost would be equal to the cost to one partner of a policy taken out by him as and on the partner's life. The contributions to premiums could be allocated in accordance with any formula, e.g., capital contributions, profit-and-loss shares, etc. Of course, the premiums could be maintained by funding the trust with securities, which would, in this instance, involve a very large initial capital outlay.

Business insurance is also often used in close corporations to provide funds for purchase, either by the corporation or the stockholders, of the stock interest of a deceased stockholder, where it would be undesirable, and probably unprofitable, for the stock to be sold outside the group which owns and operates the enterprise. Insurance companies report an upswing in the purchase of large insurance policies (including many instances of \$1,000,000 or even larger policies) by partnerships and corporations to handle problems arising on the death of "key men" in their firms, and also by individuals to make available funds to survivors for estate tax payments thereby avoiding the necessity of liquidating a stock or partnership interest to raise money. Wall Street Journal, Dec. 12, 1960. Both in the case of corporations and partnerships, the insurance trust would seemingly commend itself as a device for conveniently managing the insurance on the lives of stockholders, especially where there is cross-insurance by stockholders on each others' lives. See 2 O'NEAL, CLOSE CORPORATIONS §§ 7.25-7.26 (1958).

One important point should be remembered in connection with the purchase of business insurance by the corporation, rather than by reciprocal insurance by shareholders on each others' lives. If the corporation pays the premiums, and the beneficiaries are persons other than the corporation, e.g., the wife and children of the insured-stockholders, the premiums will be treated as taxable income to the insured. Frank D. Yuengling, 27 B. T. A. 782, 785 (1933), *aff'd on that point*, 69 F. 2d 971, 972 (3d Cir. 1934) (insured was sole stockholder of the corporation); George Matthew Adams, 18 B. T. A. 381, 384 (1929) (insured was majority stockholder); N. Loring Danforth, 18 B. T. A. 1221 (1930). The theory is that the premiums are a form of compensation to the employee even though the insurance was purchased by the corporation "primarily for its own benefit." George Matthew Adams, *supra* at 384. For a stock purchase plan benefiting the corporation, it is more convenient for the corporation to be named as beneficiary, thus receiving the insurance proceeds on the stockholder's death, and applying them promptly to buy out his stock from his estate.

C. "Income"

Section 677(a) (3) treats the insurance trust grantor as personally liable for taxes only upon the portion of the trust whose "income" is applied to premiums on the grantor's life insurance.⁵³ Accordingly, the cases indicate that whether trust "receipts" are "income" for purposes of grantor taxation, is a judicial question depending largely upon whether it would be fair and equitable to subject the grantor to taxation under the circumstances. This is illustrated by *Percy M. Chandler*,⁵⁴ already noted,⁵⁵ where the grantor had contributed from his personal funds additional sums of money to the trustee to enable the trustee to pay premiums on the grantor's life insurance. Clearly, these contributions would be taxable "income" to the trust. The Board, however, rejected the Commissioner's contention that since the contributions were applied to the grantor's life insurance premiums, section 167 (a) (3) imputed it as "income" to the grantor. This construction of the statute would have entailed double taxation upon the grantor, when he received and was originally taxed upon the amount contributed, and then again upon the same contributions imputed to him because of their use by the trust. Emphatically rejecting the Commissioner's argument, the Board declared that the statute did not "attempt to label receipts by the trust" but "deal[s] only with income to the trust" which is imputed to the grantor "to the prescribed extent of its use for the payment of insurance premiums."⁵⁶

Similarly, in *Frederick K. Barbour*,⁵⁷ the taxpayer's wife, the beneficiary of income trusts established by the taxpayer, applied a sizeable item of trust income received by her to a policy which she had previously taken out on the taxpayer's life. The Board of Tax Appeals, sitting en banc, rejected the Government's contention that the trust income had indirectly been used to pay the premiums on the taxpayer's life insurance and should therefore be taxed to him under section 677(a) (3)'s predecessor. A minority of five judges

53. Section 671 provides that whenever the grantor or some other person is treated as trust owner, he is entitled to "those items of income, deductions, and credits against tax of the trust" which are attributable to the portion of the trust on whose income he is taxed.

54. 41 B. T. A. 165, 177 (1940), *aff'd* 119 F. 2d 623 (3rd Cir. 1941).

55. See text at note 44 *supra*.

56. *Percy M. Chandler*, 41 B. T. A. at 170 (1940).

57. 39 B. T. A. 910 (1939), *rev'd on other grounds*, 122 F. 2d 165 (2nd Cir. 1941).

concurrent in the result on the specific statutory ground that within the meaning of the statute "[n]o part of the 'income of a trust' was 'applied to the payment of premiums,'" since the taxpayer's wife had "applied her own funds . . . even though it was money *from* the trust. Congress never intended to tax such an amount to the grantor."⁵⁸ It is not entirely clear what advantage the concurring judges discerned in this ground rather than the now quite standard majority rationale that the voluntary and uncontrolled use of one's personal funds received from a trust to pay premiums on the trust grantor's life insurance policies, even within the closely-knit family group, precludes imputing that income to the trust grantor.⁵⁹ The two opinions present facets of the same idea. The majority view does no more than to define the character of trust "income," stressed by the minority, and in effect, holds that if the income is substantially detached from the trust and the grantor before being applied to the insurance premiums, as it is when it is unreservedly given to a beneficiary who voluntarily uses it for that purpose, it is no longer "income of [the] trust" within the meaning of section 677 (a) (3). The minority's fear that the majority was incubating a distinction "between policies taken out by the grantor and policies taken out by others on the grantor's life"⁶⁰ is groundless, since it clearly has not made any difference who took out the policies if "income of a trust" is or may be used to support policies on the life of the trust grantor.⁶¹

Thus, it is apparent that not all trust receipts or income in a loose sense of the term, even when used for the grantor's

58. *Id.* at 915.

59. *Id.* at 913. A number of cases, more or less following the theory of the majority, have established that a beneficiary's voluntary application of payments from the trust to premiums on the trust grantor's life insurance does not entail any § 677(a) (3) tax liability upon the grantor, absent agreement, or facts implying an arrangement, with the grantor that the funds be so applied. *Lewis Barker*, 2 CCH Tax Ct. Mem. 797, 801 (1943) (good statement of the principle); *Stephen Hexter*, 47 B. T. A. 483, 489-491 (1942); *Frederick K. Barbour*, 39 B. T. A. 910 (majority opinion), *rev'd* 122 F. 2d 165 (2nd Cir. 1941); *George F. Booth*, 3 T. C. 605 (1943).

60. 39 B. T. A. at 916. The minority may have been unduly alarmed at some loose language in the majority opinion, *id.* at 913-14.

61. It could also be said that a trust beneficiary who voluntarily elects to spend his income from the trust on the grantor's insurance policies is, in reality, an "adverse party", and therefore insulates the trust grantor from any personal income tax liability on the funds so used. This would seem to be the case even if the insurance policies were in trust, for it is clear that the grantor is tax immune when the trust income is directly applied to the policies if an "adverse party" can but does not object. See the discussion of "adverse party" immediately *infra*.

insurance premiums, constitutes "income of a trust" for purposes of grantor taxation. In brief, the phrase has some element of words of art.

D. "Adverse Party"

A great many of the efforts to escape section 677(a)(3)'s restrictions have centered upon the introduction of persons other than the grantor with discretion, real or apparent, to apply or not apply income from the grantor's trust to the grantor's insurance policies. As noted, it is well settled that the fact that other persons, by arrangement with the grantor, take out insurance on the grantor's life or pay the insurance premiums does not insulate the grantor from personal income tax liability. Thus in *Arthur Stockstrom*,⁶² a grantor authorized the trustee to invest principal and to purchase and keep up insurance upon the grantor's life. The Tax Court's decision taxing to the grantor the income so applied implicitly determined that this action by the trustee, presumably an independent trustee, did not prevent operation of the statute, since trust income was actually expended on the grantor's life insurance. The fact that this was the work of one whose relation to the grantor was not technically that of an agent did not justify freeing the grantor from the tax.⁶³ An opposite result would eviscerate the statute, since nothing could be simpler than vesting the discretion in the trustee.⁶⁴

Similarly, it is well established that if, by agreement or other arrangement with the grantor, a beneficiary applies the trust income to the grantor's life insurance policy premiums, the income will be taxed to the grantor.⁶⁵ An agreement is the obvious case, but a beneficiary's action at the "suggestion" of the grantor, or through some "arrangement," however indirect or devious, would be no different. It is probable that the same result would also follow if the Govern-

62. 3 T. C. 664 (1944).

63. The Tax Court dismissed any contentions based on the fact that the insurance policies were taken out after the creation of the trust, and that the trustee had thus acted independently in applying income to that purpose. "Whether the trust antedated the policies or the policies antedated the trust, seems as irrelevant in construing the legislative purpose as any question concerning the chronological priority of the egg and the chicken." 3 T. C. at 668. See also *Frederick K. Barbour*, 39 B. T. A. 910, *rev'd on other grounds*, 122 F. 2d 165 (2d Cir. 1941).

64. Treas. Regs. § 1.672(a)-1(a) specifically provide that "a trustee is not an adverse party merely because of his interest as trustee." See also Treas. Regs. 118, § 39.166-1(b) and 39.167-1(b)(2).

65. See Part V (E) *infra*.

ment were able only to show that the beneficiary was under the "control" of the grantor, although not specifically establishing that the particular decision to apply or not apply income had been influenced by the grantor. However, it is doubtful that the requisite "control" would be inferred without more from the existence of the family relationship. But in all events, a rule of substance rather than form governs, and both statute and case law are sufficiently developed to invalidate any scheme the substance of which is to secure for the grantor the benefit of insurance upon his own life through some understanding either express or implied from the facts.

It is probable that even if there were no specific statutory base, the courts would reach the substance of these results, on the ground that the statute would otherwise be thwarted, (as in the example of the trustee) or that some other person was really acting for the grantor. As it is, in the 1954 Code there is a statutory basis in the concept of the "adverse party," corresponding to the "substantially adverse interest" of the 1939 Code and the decisions interpreting that provision.⁶⁶ An adverse interest is usually understood as some economic or financial interest in the trust which would be eliminated or impaired by action of the grantor or other persons. The existence of an essentially selfish concern in the "adverse party" is evidently considered a sufficient guarantee that the grantor cannot readily achieve through that person what is foreclosed to him by direct maneuvers, that is, the willing application of trust funds to the grantor's insurance premiums. To overcome the "adverse party's" self-interest would demand some "control" or "agreement" or "arrangement," and this presumably could be detected, and the true relation of the parties adjusted.

Under section 677(a) (3), trust income applied to the grantor's life insurance premiums will not be taxed to him if the "approval or consent" of an adverse party is forth-

66. See *D. G. McDonald Trust*, 19 T. C. 672 (1953), *aff'd sub nom. Chase Nat'l Bank v. Commissioner*, 225 F. 2d 621, 627-28 (8th Cir. 1955), *cert. denied sub nom. Thompson v. Commissioner*, 350 U. S. 965 (1956). The First Circuit ruled in *Camp v. Commissioner*, 195 F. 2d 999, 1004 (1st Cir. 1952) (*semble*) that to qualify an interest as substantially adverse it must be susceptible to monetary valuation. See also *Treas. Regs. § 1.672(a)-1(a)* (value of the claimed adverse interest must be "not insignificant" relative to total value of the trust corpus). The classic exposition of the thinking behind the "adverse party" requirement is Judge Magruder's opinion in *Fulham v. Commissioner*, 110 F. 2d 916, at 918-19 (1st Cir. 1940).

coming. Conversely, absent such "approval or consent," the grantor is taxable, as he is also if a merely "non-adverse party" is vested with discretion to use the trust income in this manner. Thus, the trustee had no "substantial adverse interest" under the 1939 provision, and, a fortiori, he is no "adverse party" under the current statute. On the other hand, as the cases already discussed show, an income beneficiary may be an "adverse party," especially when he acquires the income without conditions or restrictions as to its use, and pays for premiums on insurance on the grantor's life. Thus, we can integrate the "adverse party" concept with the decisions refusing grantor tax liability for income freely and voluntarily applied by a beneficiary to insurance on the grantor's life policies. Similarly, we can explain the grantor's liability where there is "agreement" or "arrangement" with an income beneficiary on the ground that this converts an ordinarily "adverse party" into a "non-adverse party" in whose "discretion" income is being applied to premiums. Thus, there seems to be under the 1954 Code continued vitality for the earlier decisions which, indeed, the "adverse party" phrase codifies.

The definition of "adverse party" in section 672(a) bears out this analysis, and adds refinement to the prior decisions. Quite properly, an "adverse party" must have something more than a token or minimal interest which is only theoretically opposed to, or impaired by, some application of trust income to insurance premiums; he must have a "substantial beneficial interest" before he can insulate the grantor by consenting to the use of income for insurance premiums. Of course, there are no rules of thumb to demonstrate in each case whether an interest is or is not "substantially beneficial."

The "adverse party" concept thus makes it clear that under the 1954 Code an income beneficiary is normally an "adverse party" and that his use of part or all of the income distributed to him to keep up policies on the grantor's life is outside section 677(a) (3). Of course, the beneficiary is taxed on what he receives or is entitled to receive from the trust whatever he does with it, but he is presumably taxed at lower brackets. Furthermore, many beneficiaries, for example a spouse or child, will have an insurable interest in the grantor's life, and will have independent and self-interested reasons for purchasing insurance on such a per-

son's life. Thus, there is no infallible basis for arguing, as the Commissioner might well contend, that if a beneficiary applies his trust income to the trust grantor's insurance policies this raises an inference that the beneficiary is acting for the benefit of the grantor and therefore is only in form an "adverse party." Accordingly, the "adverse party" may play the central role in "an unexplored form of insurance trust," now fortunately "explored" by Albert Mannheimer,⁶⁷ a leading scholar in this field.

In Mannheimer's basic case, a father creates an irrevocable funded trust, the income from which pays the insurance premiums unless the son demands, as he has the right to demand, that the income be paid to him. The son is an "adverse party," and the trust income, though used for the premiums, is not taxable to the father but only to the son (even though the income is renounced). Variations suggested by Mannheimer would free the son of any income tax,⁶⁸ and possibly of gift tax liability arising from the renunciation of the income.⁶⁹

In this area, there are risks, since the Commissioner is doubtlessly disposed to view such trusts with a skeptical eye because of the likelihood of an "arrangement" with a grantor. Besides evidence of an agreement or understanding that the beneficiary would use the income for the grantor's insurance premiums, factors to be considered would include, *inter alia*, the fact that the entire income goes for that purpose, the lack of any motive or incentive on the beneficiary's part to renounce income he might otherwise more enjoyably use,

67. Mannheimer, Wheeler and Friedman, *An Unexplored Form of Insurance Trust*, 34 TAXES 494 (1956). The article contains a detailed analysis of several types of trust provisions with carefully reasoned arguments as to their tax consequences. It is appropriate at this point to acknowledge the great debt owed by this paper, and indeed by any study in the area of insurance trust taxation, to the pioneer work of Messrs. Mannheimer and Wheeler in their article, *Trusts of Insurance on Relatives' Lives*, 27 TAXES 453 (1949). The 1956 article is of equal importance in this field.

68. In the most interesting suggestion, the son cannot demand income but can require the independent trustee to distribute the income to members of a class composed of the son and issue, or, in default thereof, to use the income for premiums. The son remains an "adverse party", thereby delivering the grantor of tax; the son escapes tax since his "sprinkling" power is not exercisable solely by himself; gift tax liability may be escaped (see 34 TAXES at 499-500); and if income is used for premiums, only the trust is taxed.

69. Gift tax liability arises from the fact that the right to demand income being a general power of appointment [§ 2514(c)], if released [§ 2514(b)] or even allowed to lapse [§ 2514(e)] constitutes a taxable gift of a future interest not subject to the annual gift tax exclusion.

the fact that the beneficiary was in some way compensated for renouncing income for use on the premiums, a near simultaneity in creating the trust, and the beneficiary's insuring the grantor's life. These facts are of unequal weight, but they may support the inference. It would certainly seem that the mere fact that the beneficiary is in form an "adverse party" would be insufficient protection, if, as we have suggested, too close an association with the grantor's estate planning activities suggests an "agreement" or "arrangement" and the beneficiary is, in fact, "non-adverse."

E. *"Is, or . . . May Be"*

1. The Problem and the Cases

The 1939 Code declared the trust grantor personally taxable where "any part" of the trust income "is, or . . . may be applied" to premiums on the grantor's life insurance policies. The meaning of this disjunctive phrase was the subject of several important pre-1954 cases which probably retain their full vitality today under the identical phrase in the 1954 Code's section 677(a)(3).

Leaving aside the obvious fact that the grantor is taxable when trust income "is" applied to his life policies, the statute, literally read, signifies that he is also taxable whenever the income "may be" so used, whether or not "any part" was, in fact, used in this fashion. Thus, the bare unexercised authority to use the income could arguably entail grantor liability for the income which the trust earned and which might have been but was not in fact used for the grantor's insurance policies. This raises a question whether, absent some language in the trust declaring that trust income "may [not] be" applied to premiums, the trust income is taxable to the grantor. To treat it thus would have far reaching significance, for it would imply that wherever there was no such prohibition by state law or by the trust itself, and the trustee had an area of discretion in using the income, the trust income would automatically be taxed to the grantor, on the theory that it "may be" used since that use is not proscribed.⁷⁰ Thus, many trusts which were never contemplated as insurance vehicles would expose their grantors to potential personal tax liability.

70. Indeed, on this theory the entire income would be imputed to the grantor since all of the trust income might be used in this way.

That this argument for so reading 677(a)(3) is not merely fanciful semantics is evident from the fact that it was frequently and vigorously pressed by the Commissioner in section 167(a)(3) cases, and that it achieved Supreme Court endorsement in a case under the related provision of section 167(a)(2).⁷¹ That the contention is not merely antiquarian is apparent since unchanged language in the 1954 Code affords the same basis for the argument. The Tax Court, however, with some court of appeals endorsement, consistently⁷² took the position under section 167(a)(3) that an unexercised trustee power to apply income to the grantor's life insurance policies does not entail the grantor's personal tax liability.

In *Genevieve F. Moore*,⁷³ the taxpayer created irrevocable trusts containing a provision that "the trustees may invest in and/or pay the premiums upon any life insurance contracts or annuities for the benefit or welfare of any beneficiary or beneficiaries thereunder."⁷⁴ The Tax Court rejected the Commissioner's argument that the entire income was taxable to the grantor since it "may . . . be" though in fact was not applied to insurance policy premiums:

71. *Helvering v. Stuart*, 317 U. S. 154 (1942).

72. For a useful chronological review of these cases involving the "may be" phrase in old § 167(a)(3), see Durant, *Trust Income and the Payment of Premiums*, 27 TAXES 904 (1949). Charles Stewart Mott, 30 B. T. A. 1040 (1934), *rev'd*, 85 F. 2d 315 (6th Cir. 1936), an early case decided by a split panel of the Board, alone intimates approval of the Commissioner's argument on the scope of the "may be" phrase. Here several funded trusts empowered the trustee (who was also the grantor) "to pay from income of this trust, the premiums on such insurance as may be taken out for the benefit of the beneficiary of this trust" (30 B. T. A. at 1041). The income beneficiaries, rather than the trustee, paid the large annual premiums on the grantor's life insurance; and the Commissioner included the "entire income of all three trusts" (*id.* at 1043) in the personal income. In sustaining the constitutionality of a tax so computed the Board concluded that "the fund was available for such use and was under the control of the taxpayer, in order to bring its decision within the principles of *Burnet v. Wells*, 289 U. S. 670 (1933) and *duPont v. Commissioner*, 289 U. S. 685 (1933) upon which it specifically relied. The breadth of the decision is emphasized by the dissent's point that the premiums were paid by the beneficiary out of non-trust income and without any agreement or arrangement with the grantor. Later decisions would doubtlessly approach the problem in this way, and lacking evidence of an "arrangement", exempt the grantor from personal tax liability. Although it is not fashionable to question the constitutionality of any federal tax, it would seem that *Wells* and *duPont*, involving trust income actually used for insurance premiums, do not inevitably sanction imputing income to the grantor under the circumstances shown here. Today, moreover, it could be said that absent agreement, the beneficiary is, at the least, a substantially adverse party using the income, and that he has a concrete and independent interest in taking out and keeping up insurance on another's life.

73. 39 B. T. A. 808 (1939).

74. *Id.* at 810.

[W]hile on its face section 167(a)(3) might appear to apply, it has, so far as can be discovered, never been considered applicable even by the respondent as broadly as is now suggested.⁷⁵

In at least five other cases this argument was unsuccessfully urged upon the basis of trust provisions expressly granting the power to buy insurance.⁷⁶ It has, indeed, even been pressed where the trust contained no such authority, on the ground that "since there is no prohibition against application [of the income] to the payment of life insurance premiums on the life of the grantor," the trust income, despite its use for other purposes, might be so used, and is therefore imputed to the grantor. This extreme view was rejected in *Corning v. Commissioner*⁷⁷ which ruled that the absence of a trust prohibition against life insurance purchases in a state whose law permits them, does not mean that, for federal tax purposes, the trust income "may . . . be" applied for that purpose within the meaning of the statute [section 167(a)(3)]. Affirmatively, the rule seems to be that "without express or clearly implied authority in the trustee so to deal with income [to pay for insurance premiums], there may be no application of [167(a)(3)]."⁷⁸ Constitutional questions apart, this seems to be a sound doctrine, since it should be left to Congress to state specifically that it wishes to evoke the far-reaching consequences of holding that the income of every trust which legally might be applied to insurance without trust breach is ipso facto taxable to the grantor.

75. *Id.* at 812.

76. See Joseph Weil, 3 T. C. 579 (1944); Philip Meyers, 3 CCH Tax Ct. Mem. 468 (1944); Frank C. Rand, 40 B. T. A. 233, 238-39 (1939), *aff'd* 116 F. 2d 929 (8th Cir. 1940), *cert. denied*, 313 U. S. 594 (1941); Lorenz Iversen, 3 T. C. 756, 774 (1944). The Sixth Circuit also rejected the argument in *Commissioner v. Mott*, 85 F. 2d 315 (6th Cir. 1936), *rev'g*, 30 B. T. A. 1040 (1934), where the Board of Tax Appeals had favorably commented on the contention. See note 72 *supra* for a discussion of the *Mott* case.

77. 104 F. 2d 329, 333 (6th Cir. 1939). Another ground of the decision favoring the taxpayer is less persuasive, *viz.* that the trustee's power to "invest" funds does not encompass a power to purchase and keep up insurance, so that under state law trust income "may [not] be" applied for that purpose. *Id.* at 333. Other courts have taken in similar cases a contrary view on the scope of a power to "invest." See *Rand v. Helvering*, 116 F. 2d 929 (8th Cir. 1941), *cert. denied*, 313 U. S. 594 (1941); *Schoelkopf v. McGowan*, 43 F. Supp. 568, 572 (W. D. N. Y. 1942).

78. 104 F. 2d at 333. On the other hand, the absence of such an enabling provision does not preclude a grantor's personal tax liability where he, as trustee, has applied income to his insurance policies, and such expenditures are proper under state law. *Frank C. Rand*, 40 B. T. A. 233 (1939), *aff'd*, 116 F. 2d 929 (8th Cir. 1940), *cert. denied*, 313 U. S. 594 (1941).

Although a bare unexercised trustee power to apply trust income to life insurance does not expose the grantor to personal tax liability, this rule does not settle certain situations where, realistically, the trustee might have paid for insurance but did not do so. This type of problem arose in *Joseph Weil*⁷⁹ in which the income of a funded trust was, under the trust indenture, to be applied to any of the grantor's policies then in trust and to those which might later be placed in trust, the grantor having reserved a power to add policies to the trust. On the policies in trust during the taxable year the trustee paid the premiums, and the grantor conceded personal liability. Since, however, there was one policy which the grantor could have placed in trust but did not, paying the premiums himself, the Commissioner argued that trust income could have been used for the premium, and hence should be taxed to the grantor. The Tax Court in rejecting this argument fashioned a now settled rule of that Court that "the grantor's liability for tax depends upon the existence in the tax year of policies upon which it would have been physically possible for the trustee to pay premiums."⁸⁰ Here the trust instrument gave the trustee no power to pay for premiums on a policy not within the trust, and therefore the misnamed "physically possible" test was not met.⁸¹

Stated more accurately, the "physically possible" test simply means that income will not be taxed to the grantor where there are no policies upon which a trustee's admittedly valid power to pay premiums could reasonably be expected to operate, *e.g.*, where there are no such policies in existence or where they are not in trust as in *Weil*. Whether it follows in law, as it does not in logic, that the grantor is taxable on income which "may be" but is not applied to a policy in the trust during the taxable year is, of course, a question at issue. In any event, even if this is so, it is certainly

79. 3 T. C. 579 (1944).

80. *Id.* at 584.

81. Similarly, in *Genevieve F. Moore*, 39 B. T. A. 808 (1939), the Board of Tax Appeal applied the same rule to unspecified facts, finding "no evidence in the record" of "the existence in the tax year of policies upon which it would have been physically possible for the trustee to pay premiums." *Id.* at 812-813. The Court of Appeals applied this rule in a particularly narrow fashion in *Commissioner v. Mott*, 85 F. 2d 315 (6th Cir. 1936) where the trust instrument provided that the trustee should pay "the premiums on such insurance as may be taken out for one beneficiary of this trust." The Court read this phrase as referring only to policies actually taken out after the trust had been established, and not to include policies in existence prior to that time, including policies which might have been but were not taken out by the trust.

a much narrower statement of the rule than the position urged by the Commissioner that tax follows wherever application of income to insurance premiums was legally possible and not forbidden by trust instrument.

The upshot of the decisions under the 1939 Code is that the "may be" phrase has little or no independent scope or effect.⁸² Certainly, it seems that the mere existence of a trust power to apply income to insurance premiums does not alone entail grantor liability. Moreover, both the Tax Court—and, perhaps more noticeably, the few appellate courts considering the issue—have been disposed to construe the language of the trust instrument so as to avoid having to meet squarely the force of the "may be" language.⁸³ Similarly, in cases where part of the trust income was actually used for insurance premiums, this portion was concededly taxable to the grantor; but the remainder was held non-taxable.⁸⁴ There are other undecided situations which would test the theory:

- a. The trustee has discretion to pay out income to beneficiaries or to retain it, together with a power to purchase insurance or pay premiums on insurance already in force. Income is paid to the beneficiary who pays the premiums on the grantor's insurance in circumstances where no evidence of "arrangements" is available, and such evidence as there is negatives it. Is this trust income which "may be" applied to the grantor's insurance?
- b. Slightly varying the *Weil* case's facts, a trustee has power to keep up insurance, whether or not it

82. One court has said that old § 167 (corresponding to INT. REV. CODE OF 1954, § 677) required a strict construction. *United States v. Stroop*, 109 F. 2d 891 (6th Cir. 1940).

83. Note the Sixth Circuit's niggardly construction of the trust power in *Commissioner v. Mott*, 85 F. 2d 315 (6th Cir. 1936), *rev'g*, 30 B. T. A. 1040 (1934). For a brief statement of the facts, see note 72 *supra*. The court of appeals construed the language of the trust instrument to authorize the trustee to apply trust income only to policies which might be taken out in the future, and although trust beneficiaries were paying large premiums on the grantor's life policies, there was no ground for contending that trust income "may be" applied to such premiums. Of course, the trust did not in fact pay the premiums; the issue was whether, for tax purposes, trust income "may be" used for them. *Cf.* cases holding the grantor taxable where trust beneficiaries pay premiums by arrangement or agreement with the grantor. See Part V (E) *infra*.

84. *E.g.*, *Frank T. Heffelfinger*, 32 B. T. A. 1232 (1935), and *Philip Meyers*, 3 CCH Tax Ct. Mem. 468 (1944) squarely ruling that "[p]etitioner is taxable only upon the actual premiums paid by the trusts for insurance on his own life but is not taxable upon the trust income in excess of that amount." *Id.* at 473.

is in the trust itself; but within the taxable year he does not do so as to policies in force during that year.

2. Relation to *Helvering v. Stuart*

The strongest, and seemingly still viable, authority for broadly reading "may be" in section 677(a) (3) is *Helvering v. Stuart*⁸⁵ where the Supreme Court unanimously interpreted the corresponding phrase in section 677(a) (1)'s predecessor, section 167(a) (2), as taxing the grantor upon all trust income which "may . . . be distributed to the grantor." In that case, involving a support trust for minor children, the mere "possibility of the use of the income to relieve the grantor, pro tanto, of his parental obligation" of support was "sufficient to bring the *entire income* of these trusts within" his personal tax liability.⁸⁶ Although the Board of Tax Appeals—consistent with its settled practice in the insurance trust cases — had invariably refused to tax the grantor with the whole of the income "merely because a part could have been but was not used for the support of an infant," the Court consciously took the "contrary view,"⁸⁷ concluding that income "may . . . be distributed to the grantor" under section 167(a) (2), now section 677(a) (1).⁸⁸

85. 317 U. S. 154 (1942).

86. *Id.* at 170-71. Presumably, the amount so taxable to the grantor would be limited by the extent of the grantor's parental obligation, and this in turn would be judged against financial ability, the customary type and extent of past support, and like factors. See *Hopkins v. Commissioner*, 144 F. 2d 683 (6th Cir. 1944). It would seem difficult to find such built-in reasonable limits on the amount of income which "may . . . be" expended on life insurance. Hence, a construction of the "may be" phrase, which would be appropriate in the support area, might be unworkable in the insurance trust area.

87. *Helvering v. Stuart*, 317 U. S. 154, at 170 (1942).

88. Compare *Wilcox v. Commissioner*, 137 F. 2d 136 (9th Cir. 1943) holding that the entire trust income would be taxed to the grantor under § 167(a) (2), now § 677(a) (1), where the trust gave to the grantor "the net income of the trust 'or such part thereof as he may require.'" *Id.* at 140.

Durant, *op. cit. supra* note 72, mistakenly describes *Helvering v. Stuart* as a "so-called Section 22 [now § 61 of the 1954 Code] case . . . not founded upon Section 167." 27 TAXES at 908-909 (1949). This view would, by implication, wholly negative the relevance of the *Stuart* decision for any discussion of the "may be" phrase in § 677(a) (3). On the contrary, the Supreme Court specifically observed that "[i]n No. 49, the R. Douglas Stuart trusts, the minority of each of the beneficiaries brings the income from the trusts under the provisions of 167(a) (1) and (2)." *Helvering v. Stuart*, 317 U. S. 154, at 169 (1942). The subsequent discussion in the opinion proceeds on the basis of the relevance of § 167. *Id.* at 170-171.

The Tax Court subsequently adhered to its settled interpretation of "may be" in the insurance trust cases by distinguishing *Stuart* as "limited . . . to [its] facts" and "involving wholly different facts and different statutory provisions."⁸⁹ This is only partially accurate. Apart from the fact that all decisions may arguably be limited to their facts (a position which seldom should apply to Supreme Court rulings), *Helvering v. Stuart* cannot fairly be read as a narrowly limited decision based upon and meticulously confined to its particular circumstances, for it purported to be an authoritative reading of the language of section 167(a)(2). Again, whatever factual differences exist between the two situations do not directly bear upon the interpretation of the "may be" phrase in the two sections. Moreover, since in *Helvering v. Stuart* the trust funds emphatically had not been used for the support of the children, personal tax liability rested upon the existence of a bare unexercised trustee power. Analysis turned upon the "possibility" that the income might have been so used, not the fact that it had or had not. Finally, the *Stuart* construction, for purely mechanical reasons, seems to apply more forcefully under section 677(a)(3), since as that section is now arranged, the "may be" phrase precedes, and applies equally to the three subsections of 677.

On the other hand, the difference in the factual background does provide a basis for distinguishing the two provisions, so that a construction appropriate for one may be inapposite for another despite identical language. Unlike support trusts producing income which "may . . . be distributed to the grantor" only because they fulfill support obligations of the grantor to family members (the rationale of the *Stuart* decision), the insurance trust relieves the insured-grantor of no comparable obligation since obviously one is not bound to take out and keep up insurance for anyone. In short, the element of benefit to the grantor realistically is attenuated in the insurance trust situation, and may therefore justify a stricter reading of the "may be" phrase there than in the support trust case. Moreover, as noted above, a broad reading of the phrase might well raise sufficient constitutional doubt that the Court would not impute to Congress a purpose to give the phrase such breadth

The Court noted the necessity of considering the "interplay" of "both § 22(a) and § 167." *Id.* at 167.

89. Joseph Weil, 3 T. C. 579, at 584 (1944).

of meaning absent more specific language and legislative history.

In sum, *Helvering v. Stuart* stands prima facie as persuasive support for the broad reading of section 677(a)(3) which the Government once so strongly urged. Its authority here cannot be so summarily overridden as the Tax Court has done. A sound distinction necessarily rests upon an analysis, along the lines indicated, of the comparative purposes of the two sections.⁹⁰

3. Effect of the 1954 Code

As a whole, the state of the law on this point—the proper construction of the “may be” phrase—seems little altered by the 1954 Code enactment. The legislative history throws no light on the problem, since Congress gave it no specific consideration. It is true, however, that at certain hearings, the American Bar Association urged a specific provision relieving the grantor of tax on the trustee’s unexercised power to use trust income for insurance premiums, but that the Senate, without comment, failed to include such a clause.⁹¹ Such inaction at an early stage in the revision is much too equivocal and insignificant to imply a Congressional purpose to expose the grantor to taxation upon the unexercised power of the trustee.

More relevant but equally inconclusive is the effect of the immediate Congressional overruling of *Helvering v. Stuart*, now carried forward as section 677(b)’s provision that income is not taxable to the grantor “merely because” it “may be applied or distributed” so as to meet the grantor’s support obligations under local law.⁹² Its implications are conjectural only.⁹³ Limited as it is to the *Stuart* holding,

90. To press this point further: it would seem that a support trust for minors whom the grantor is not obligated to support, e.g., children of a distant though dear relative or friend, would not yield income which “may . . . be distributed to the grantor” since they relieve the grantor of no obligation (rationale of the *Stuart* decision). Section 677(a)(3) has no such built-in limitation. If “may be” is as broadly read here, logically the grantor is personally taxable with respect to *every* insurance trust, whether for family or stranger beneficiaries. Thus, the same phrase interpreted in the same way but without regard to the background of the two sections would have sharply different consequences.

91. See note 34 *supra*.

92. Revenue Act of 1943, § 134, 58 Stat. 51; See S. REP. NO. 627, 78th Cong., 1st Sess. 29 (1943).

93. The legislative history merely says § 677(b) duplicates § 167(c) of the 1939 Code, and that “[n]o change in substance is made.” H. REP. NO. 1337, 83d Cong., 2d Sess. (1954), U. S. CODE CONG. & AD. NEWS 4357

section 677(b) does not necessarily preclude arguing the *Stuart* construction of "may be" under 677(a)(3). After all, Congress was called upon to deal with the "may be" phrase only in its application to support trusts, and not to go further and state a general rule of construction governing insurance trusts as well. If section 677(b) persuades, it is by analogy only. In any event, such conviction as the analogy carries is weakened by the countervailing technical contention that section 677(b)'s specific reference to the *Stuart* problem impliedly leaves unaltered the law on matters not covered by *Stuart*—the venerable *inclusio unius exclusio alterius* argument.

A third point is that the pre-1954 decisions narrowly reading the "may be" clause in insurance trust situations are probably still viable. To support the view that "may be" is still to be narrowly construed under section 677(a)(3), it is unnecessary to resort to the dubious fiction that Congress, by re-enacting section 167(a)(3) substantially unchanged, necessarily adopted and approved the pendant judicial gloss to the former section.⁹⁴ It is enough to say, that upon viewing this established line of rulings, a silent rejection of these decisions, which would mean a revision of the law, cannot reasonably be implied where substantially the same statutory language continues to be used in the new provision, and nothing else points to an intended change.⁹⁵ Ac-

(1954). See also S. REP. No. 1662, 83d Cong., 2d Sess. (1954), at U. S. CODE CONG. & AD. NEWS 5012 (1954).

94. "The reenactment by Congress, without change, of a statute, which had previously received long continued executive construction is an adoption by Congress of such construction," *United States v. Cerecedo Hermanos*, 209 U. S. 337, 339 (1908), and thus "bespeaks Congressional approval" of such interpretation, *Corn Products Ref. Co. v. Commissioner*, 350 U. S. 46, 53 (1955). Many cases follow the rule, See 1 DAVIS, ADMINISTRATIVE LAW § 5.07 (1958). The Supreme Court has also applied it to interpretations other than those formalized in administrative regulations. Contrast *NLRB v. Gullett Gin Co.*, 340 U. S. 361, 365-366 (1951) with *NLRB v. Seven-Up Bottling Corp.*, 344 U. S. 344, 351 (1953). The Court has, however, recognized that the re-enactment rule has not always been stated or applied in "entirely consistent terms," *Helvering v. Griffiths*, 313 U. S. 371, 396 (1943), and even noted that it "is an unreliable indicium at best." *Commissioner v. Glenshaw Glass Co.*, 348 U. S. 426, 431 (1955). In Davis' view, the rule is best regarded, as Chief Justice Hughes said, *Helvering v. Reynolds*, 313 U. S. 428 (1941), as "no more than an aid in statutory construction," and as not "likely to divest the Supreme Court from giving effect to a deep conviction concerning policy." Davis, § 5.07, *supra*, at n. 14. Thus, where re-enactment has taken place without "any congressional discussion which throws light on [the section's] intended scope," the re-enactment has been treated as "without significance." *United States v. Celanano*, 354 U. S. 351, 359 (1957).

95. The most recent straw in the wind — noted for what little it is worth — appears in the history of the so far unenacted Trust and Partnership

cordingly, it is strongly arguable that the closely confined interpretation of the "may be" phrase under the 1939 Code survives under section 677(a) (3).⁹⁶

4. Da Capo—A Final Caveat

All of these arguments are, of course, largely conjectural. Behind them undeniably stand the bare words of the statute, backed up by Supreme Court and other statements that the "plain language" of a statute will govern.⁹⁷ Despite the

Income Tax Revision Bill of 1960. H. REP. No. 9662, 86th Cong., 2d Sess. (1960) [originally introduced in the 1st Session as H. REP. No. 3041 (1959)]. The Advisory Group on Subchapter J, headed by Professor Casner of Harvard, noted that "[t]he present language of section 677(a) (3), if literally applied, may cause the grantor of a trust to be treated as the owner of the trust income in some situations where it is questionable whether the grantor should be so treated." Final Report, Advisory Group on Subchapter J at p. 57 (submitted Dec. 29, 1958). The committee then gives two typical examples of possible grantor taxation upon the entire trust income on the theory that the entire income might be used for the grantor's insurance premiums, (although it is not), and notes that it "may be necessary" to negate a power in the trustee to acquire insurance or pay premiums thereon. *Id.* at 58. The committee urged the following language which would treat the grantor as trust owner when trust income "is . . . or may be"

(3) applied to the payment of premiums on policies of insurance on the life of the grantor —

(A) *in which the grantor possesses any incident of ownership; or*

(B) *in which the grantor possesses no incident of ownership but only to the extent of premiums payable with respect to such policies of insurance in existence during the taxable year [except policies for charities].* (recommended addition in italics) *Id.* at 58.

This provision was, however, deleted by the House Ways and Means Committee [H. REP. No. 1231, 86th Cong., 2d Sess. 72-73 (1960)] and the Senate Finance Committee [S. REP. No. 1616, 86th Cong., 2d Sess. 66-67 (1960)], without comment other than the unilluminating observation that "[e]xisting section 677(a)" provides for grantor taxation on trust income which is or may be used for premiums "on certain policies of insurance on the life of the grantor." H. REP. No. 1231 at 72; S. REP. No. 1616 at 66. About the only permissible inference is that Congress did not care to take any position on this matter.

96. The swift "correction" of *Stuart* in its context suggests Congressional distaste for an interpretation which visits upon the grantor, merely because of a trustee's unexercised power (either declared in the trust or implied from its non-prohibition under state law), heavy tax liabilities which are neither contemplated nor rest upon any meaningful connection between the grantor and the trust income during the period of the power's non-user. It is perhaps more likely than not that the *Stuart* interpretation transplanted to the insurance trust would also evoke legislative "correction."

97. "There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning." *United States v. American Trucking Ass'ns*, 310 U. S. 534, 543 (1940). The "plain meaning" rule is often a weak reed on which to lean in view of the disposition of the federal courts to accept and examine legislative history of the statute under construction, but it is at least a beginning point. The touchstone is the "purpose" of the legislation; if statutory wording is at "variance with the policy of the legislation

weight of precedent and the Commissioner's inaction in recent years, the possibility that this contention may be revived should not be overlooked. Trusts avowedly intended as insurance vehicles will face this risk. As for other trusts, it is desirable, absent some reason for inclusion, to omit a power to deal with the grantor's life insurance, and perhaps out of an abundance of caution, negative it.⁹⁸

V. TRUSTS OF INSURANCE ON THE LIFE OF A PERSON OTHER THAN THE GRANTOR

Since section 677(a)(3), like its predecessors, taxes to the grantor only the trust income which "is or may be" applied to insurance on the *grantor's* life, it follows logically from the statutory language—as indeed the cases unanimously confirm—that a grantor may fund a trust of policies on the life of another in whom he has an insurable interest, and avoid personal income tax liability under section 677(a)(3). Thus, a wife might establish a trust to keep up policies on her husband's life, or vice versa. Similar arrangements would be possible as between parent and child, brother and sister, uncle and nephew, and so on to the limits of insurable interests.⁹⁹ The fact that tax reduction motives inspire the particular transaction is immaterial so long as the arrangement does not in substance constitute a trust of insurance on the grantor's life. If the income tax immunity of trusts of insurance on another's life is a tax "loophole," it is one which Congress has accepted since 1924, and which the courts have not felt it their duty to close.

At the outset, one important matter must be stressed. The fact that the insurance is on the life of someone other than the grantor does no more than relieve the grantor from such personal income tax liability as section 677(a)(3) might exact from him. However, the grantor may nevertheless be taxed on the trust income under other Code sections unless the trust conforms to their specific requirements.¹⁰⁰

as a whole" or produces "absurd" or "unreasonable" results, that purpose, rather than the literal words, will govern. *United States v. American Trucking Ass'ns*, 310 U. S. at 543.

98. This is recommended in 6 MERTENS, *FEDERAL INCOME TAXATION* § 37.49, at n. 34 (1957).

99. Stockholders in a close corporation, and partners, have insurable interests in each other's lives; and a corporation can similarly hold insurance on the life of a majority or dominant shareholder. See generally note 52 *supra*.

100. See *infra* at Sections V (D) and VI (A).

The same is true *mutatis mutandis* with respect to certain doctrines of the "common law of taxation."¹⁰¹ In sum, section 677(a)(3) is not exclusive. Usually, the occasion for personally taxing the grantor on a section 677(a)(3) immune trust is his retention of various powers, thereby potentially converting the insurance arrangement into a *Clifford*-type trust. This is discussed *in extenso* in the succeeding section, but a general caveat is in order here: the sections which codify the *Clifford* concept considerably narrow the choice of insurance trusts, even though they fall outside section 677(a)(3), because the insurance is on the life of some person other than the grantor.

Wholly apart from income tax aspects, other tax consequences, as well as non-tax estate planning considerations, come into play, and may well override possible income tax savings. It hardly needs emphasis that such considerations must always be given due weight in deciding upon the use of an insurance trust—an admonition that is applicable in planning any transactions where tax and non-tax aspects may compete. First of all, just as in the case of a projected trust of insurance on the grantor's life, an irrevocable¹⁰² gift of securities or other property to fund the trust of insurance on the life of someone other than the grantor is a completed gift subject to gift tax,¹⁰³ except as it may be offset by the lifetime exemption¹⁰⁴ and by annual exclusions.¹⁰⁵

This further highlights the potential application of the *Clifford* income tax rules to an insurance trust, for if the property transfer is incomplete the trust income (and not

101. See *infra* at Section VI (C).

102. Irrevocability is essential because otherwise the grantor would be treated as trust owner "where at any time the power to revest in the grantor title to such portion of the trust is exercisable by the grantor on a non-adverse party, or both." INT. REV. CODE OF 1954, § 676(d). If the power to revoke can take effect only after 10 years, the grantor is not "treated as the owner" of the trust prior to the expiration of that time period. § 676(b).

103. The gift tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." INT. REV. CODE OF 1954, § 2511(a). Commissioner v. Beck's Estate, 129 F. 2d 243 (2d Cir. 1942), sustained a gift tax on securities irrevocably transferred to fund an insurance trust conceded subject to income tax under § 167(a)(3), rejecting the grantor's contention that he was entitled to deduct "the commuted value, according to the actuarial tables, of the income on which the grantor would have to pay income tax" under § 167(a)(3). *Id.* at 244.

104. INT. REV. CODE OF 1954, § 2521. It is presently fixed at \$30,000.

105. INT. REV. CODE OF 1954, § 2503(b). It is presently fixed at \$3,000.

just the premiums paid by the trustee) will be charged to the grantor's gross income, even though the insurance does not protect his own life. This is the case, for example, where the trust is revocable,¹⁰⁶ or the grantor retains a reversionary interest¹⁰⁷ or certain other powers.¹⁰⁸ Again, we emphasize the likelihood of this result, since it has been almost customary for grantors to retain extensive powers over their insurance trusts.^{108a} Under these circumstances, which invite federal gift taxes, the securities funding the trust may appear in the gross estate.¹⁰⁹ In any event, the near-death transfer of such property for this purpose will likely be a "gift in contemplation of death," and the securities will be included in the gross estate¹¹⁰ (although the insurance proceeds will not necessarily be included).

The significant estate tax advantage of insurance today is that the *proceeds* payable after death are not included in the gross estate, unless (1) they are payable to the executor, or (2) at death the decedent possessed "incidents of ownership" in the policies.¹¹¹ As to point (1), payments to named beneficiaries (other than the executor) do not fall into the gross estate, and this includes beneficiaries of insurance in trust. As to (2), the decedent greatly enhances the probable exclusion of the proceeds from his gross estate by using an insurance trust which is irrevocable and as to which he has renounced all powers normally retained under the policies and too often, and too needlessly, reserved under the trust. The insurance trust (unless funded in contemplation of death), also eliminates the possibility, inherent in direct payments of premiums to policies in an unfunded trust, that premium payments just before death may themselves be deemed gifts in contemplation of death.

Estate planning considerations are only briefly considered since this article focuses upon income tax consequences. However, tax savings can seldom be obtained without a price,

106. INT. REV. CODE OF 1954, § 676.

107. INT. REV. CODE OF 1954, § 673.

108. INT. REV. CODE OF 1954, §§ 674-75.

108a. See text at note 8 *supra*.

109. INT. REV. CODE OF 1954, § 2033 broadly provides that "[t]he value of the gross estate shall include the value of all property . . . to the extent of the interest therein of the decedent at the time of his death." See also § 2038 including in the gross estate the value of transferred property subject at the decedent's death to his power to "alter, amend, revoke, or terminate."

110. INT. REV. CODE OF 1954, § 2035.

111. See INT. REV. CODE OF 1954, § 2042.

and the estate planner must inevitably weigh the advantages of income and estate tax saving against divesting the insured of the control which he might otherwise retain with respect to his insurance. Inescapably, this is a judgment possible only after an exhaustive and informed study of the circumstances of the grantor, his family relations, his objectives, and his hopes and fears for the future.

A. *Non-677(a)(3) Trusts: Grantor Contributes Insurance Policies (on Another's Life) and Funds Trust*

The simplest type of trust lying outside section 677(a)(3) is a single funded trust to keep up insurance on the life of some person other than the grantor.

1. Within this category, the typical device is for a wife to fund a trust of policies on her husband's life. A line of cases both in the lower courts¹¹² and in the Tax Court (and the predecessor Board of Tax Appeals)¹¹³ have firmly established that such a trust is immune under section 677(a)(3) since it does not involve insurance on the life of the grantor of the trust.¹¹⁴ From an estate planning perspective, this has much

112. *Commissioner v. Jergens*, 127 F. 2d 973, 974 (5th Cir. 1942); *Rockwell v. Granger*, 62 F. Supp. 907 (W. D. Pa. 1945).

113. *Lucy A. Blumenthal*, 30 B. T. A. 591, 596-97 (1934) (leading case) *rev'd on other grounds*, 76 F. 2d 507 (2d Cir.), *rev'd*, 296 U. S. 552 (1935); *Gail H. Baldwin*, 36 B. T. A. 364 (1937); *Sophia P. O. Morton*, 38 B. T. A. 419, 424 (1938), *rev'd on other grounds*, 108 F. 2d 1005 (7th Cir. 1940); *Frances S. Willson*, 44 B. T. A. 582, 587 (1941), *rev'd on other grounds*, 132 F. 2d 255 (6th Cir. 1942); *Rita G. Bloomingdale*, 3 CCH Tax Ct. Mem. 1163, 1167 (1944). In the last case, W established a trust assigning eventually some \$450,000 in insurance on H's life, funded by \$500,000 in bonds. The policies had originally been issued to H who assigned 9 of the 10 policies to W four or five months prior to the trust establishment. The court rejected the Commissioner's efforts to tax the grantor under several Code provisions, including § 677(a)(3)'s predecessor.

In *Lucy A. Blumenthal*, the Board's holding that trust income applied to premiums on the insurance of a person other than the grantor is not taxable under old § 167(a)(3) was not appealed by the Commissioner either to the Court of Appeals or the Supreme Court. A note in MERTENS incorrectly implies that the Supreme Court's *per curiam* reversal of the lower court dealt with this phase of the case [see 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 37.49, at n. 23 (1957)], but the court opinions were exclusively concerned with an entirely different and separate issue. However settled the grantor's non-taxability under § 677(a)(3) in this area may be — and it appears to be solidly established — it is not true that the Supreme Court has so far given its imprimatur to this line of decisions.

114. One point should be noted here, although it takes us ahead of the story. As we shall see [Part V (D) (1) *infra*], the grantor-taxpayer's aggregated property interests in the trust of insurance on another's life may result in taxing the trust income to him personally under § 677(a)(2), on the theory that trust income is being accumulated for future distribution to the grantor, who may be named as the insurance beneficiary. In

the same advantages as if the husband himself funded a trust of his own life insurance: upon his death—presumably before his wife's—the funds are then and there available at a time when they are most likely needed. The disadvantage is that this arrangement assumes that the wife herself has the funds available to establish the trust; and as noted later, a husband rarely can escape income tax liability by transferring securities to his wife for the establishment of a trust of policies on the husband's life. But if this hurdle is overcome, a convenient estate planning method is available, with the further advantage that trust income applied or applicable to premiums is not taxed to the grantor. The probability that the Government can successfully challenge the trust is at a minimum where the policies transferred by the wife were taken out by her on her husband's life long before the transfer in trust, and where the funds are obviously her own, or have been acquired from her husband under circumstances negating the inference that they were given her for the purpose of establishing the insurance trust. As one or more of these factors disappears or is weakened, the likelihood of successful Government challenge increases.

2. A trust funded by the husband of policies on the life of his wife similarly avoids income tax liability and also solves the problem of the wife's available funds, but it may prove a crude and imprecise instrument from an estate planning standpoint. Of necessity, it can serve no purpose during the probable interval between the husband's death and that of his wife, so that it will likely benefit only the

Frances S. Willson, note 113 *supra*, the majority applied the accepted rule of non-taxability under § 677(a) (3) relying on *Blumenthal* and *Baldwin*. Dissenting, Judge Oppen thought (44 B. T. A. at 593) that the earlier court reversal in the *Morton* case, note 113 *supra*, had "deprived of all authority" these decisions on which, indeed, the Board had also heavily relied in its subsequently reversed *Morton* opinion. His view appears to be an extreme one. The court in *Morton* scrupulously avoided any comment on the general rule exempting the grantor from income tax on trust income used for premiums on the life of one other than the grantor. It stressed "the practical facts" showing that "the bulk of the income did remain, in contemplation of law, in substance, that of the grantor used to purchase property for herself" despite the fact that the property purchased was insurance on her husband's life. *Sophia P. O. Morton*, 108 F. 2d at 1007-08. This is far from denying the basic law proposition here discussed, that, as a general rule, trusts of insurance on the life of a person not the grantor entail no § 677(a) (3) income taxation to the grantor on the income used for those premiums. Contrary to Judge Oppen, the *Blumenthal* and *Baldwin* cases seem presently sturdy precedents; their authority could be thought shaded by *Morton* only to the extent that their facts would, under the *Morton* rationale, show the income to be in effect accumulated for or held for distribution to the grantor.

couple's children upon the wife's death. Assuming that the grantor's wife has been otherwise cared for, this sort of a trust has much to recommend it as a means of providing for the grantor's children. Another similar arrangement within the family is a funded trust of insurance on the life of the grantor's son with the son's children and wife designated as beneficiaries. Possible variations in this pattern for the benefit of other members of the family readily suggest themselves, and would doubtlessly leave the grantor free of section 677(a)(3) taxation. In such cases, as family ties become more remote (although still within the sphere of insurable interests), the necessity of the grantor's complete renunciation of interests in the trust and the insurance, and the possible consequences of such action, should weigh more and more heavily in his decision.

Such arrangements, as already noted, leave the husband-grantor's wife without provision. Assuming that the children or other beneficiaries of this type of insurance trust have funds of their own, they may, in conjunction with the husband's trust on his wife's life, create a trust of insurance on the life of their father with their mother named as the beneficiary, thus meeting the problem of funds for the wife should her husband predecease her. Such interlocking arrangements must be skillfully and carefully planned and drafted, for they may run, *inter alia*, the risk of being treated as reciprocal trusts¹¹⁵ with corresponding loss of personal income tax immunity.

B. Non-677(a)(3) Trusts: Two Grantors

The trusts which we have just discussed have this common characteristic, that the grantor of the trust contributed both the insurance policies and the funds to pay their premiums. Sometimes the creation of these two essential parts of a funded insurance trust is divided between two persons, one of whom furnishes the policies, the other the funding securities. Taking husband and wife as examples of a generally applicable principle, the kinds of trust we now examine fall between two poles: (1) where the husband furnishes both the funds and policies on his life, in which case he is unquestionably taxable, and (2) where the husband furnishes both the funds and policies on his wife's life, in which case he is indisputably not taxed.

115. See Part V (C) *infra*.

1. Suppose that W entrusts policies on H's life, and H supplies the funds to carry those policies. Although no case seems precisely in point, this transaction would probably result in personal income tax liability to H. Applying the words of section 677(a) (3), there is here a trust "whose income . . . is, or . . . may be . . . applied to the payment of premiums on policies of insurance on the life of the grantor." It seems unquestionable that within the meaning of this language H is "the grantor" of the trust "whose income" is so employed. This result would be no different under section 167(a) (3) of the 1939 Code.

2. The more teasing problem is the one supposedly settled by the 1944 Tax Court decision in *W. C. Cartinhour*.¹¹⁶ The pattern exemplified there is the transfer by H of policies upon his own life to a trust which is funded by W. Assuming the absence of any tax evasion scheme, such as an arranged transfer of securities by W,^{116a} the question is whether H is subject to section 677(a) (3) taxation on trust income which is or may be applied to those policies. In holding that H is not taxable, the majority in the *Cartinhour* case observed that the arguments favoring H's tax liability "at first blush may seem to be sound; for [H] was a grantor and trust income was applied to the payment of premiums upon policies of insurance on his life."¹¹⁷ But the statute "was never intended to apply" to a fact situation such as this, for "[t]he income in issue was derived solely from property contributed to the trust by [W]."¹¹⁸ The court thought that the broad test of economic benefit to the grantor stated in *Burnet v. Wells*¹¹⁹ was beside the point, since here, unlike the Supreme Court case, H "had not chosen to dedicate any of his property to preserving his contracts" of insurance.¹²⁰ Several dissenting judges offered a technical reading of the statute to support grantor taxation under these facts,^{120a} more persuasively they argued that confinement of old section 167(a) (3) "to a case where the part of the trust income so used is derived from property contributed by the insured

116. 3 T. C. 482 (1944).

116a. See Part V (E) *infra*.

117. 3 T. C. at 490.

118. *Id.* at 490-91.

119. *Burnet v. Wells*, 289 U. S. 670 (1933).

120. 3 T. C. 482 at 491.

120a. For their argument, see note 122 *infra*.

. . . is an unwarranted restriction which defeats the obvious intendment of the statute and provides a plain loophole.”¹²¹

Analytically, the majority view seems erroneous, and perhaps more obviously so on the language of section 677(a)(3) than on old 167(a)(3) under which *Cartinhour* was decided. Matching facts against the present statutory language, there is clearly a “trust” “whose income” is or may be applied to “policies on the life of the grantor.” The argument that H (who contributed his life insurance policies) is not taxable rests almost entirely upon the two words “the grantor,” since implicit in the Tax Court majority view is the premise that H was not “the grantor” within the statute’s meaning. But in turning over policies to the trust, H is at the very least “a grantor” of the trust, and indeed the Tax Court majority recognized that H in fact “was a grantor” of the trust.¹²² Certainly no one would doubt that if a man establishes an *unfunded* trust of his insurance policies, he is “the grantor” of that trust. With this fact in mind, the possible difference between the actual statutory language—“the grantor”—and the hypothetical “a grantor” seems an exceedingly slim basis upon which to ground the weight of the tax exemption carved out by the *Cartinhour* ruling. The effect, therefore, of *Cartinhour* is to restate the statute to provide in effect that “the grantor shall be treated as the owner of any portion of a trust . . . whose income, *received from property transferred by such grantor*, is, or . . . may be . . . applied” to insurance on such grantor’s life.

Other considerations support this criticism of the *Cartinhour* case. In the first place, section 677(a)(3) and its predecessors were enacted because “[t]rusts have been used to evade taxes by means of provisions allowing the distribution of the income to the grantor or its use for his benefit.”¹²³ A clearer case of trust income “use[d] for his benefit” could scarcely be conceived. Again the broad rationale of *Burnet v. Wells* does not deserve so niggardly a reading as the Tax Court majority gave it in the *Cartinhour* case. Cer-

121. *Id.* at 490.

122. *Id.* at 490. On the technical problem of statutory construction, the dissent urged that “the words *the grantor* may properly be interpreted collectively” so as to include both the contributor of the policies and of the funding securities. *Id.* at 493. Whatever the approach, the degree of generosity in reading the statutory words depends first and foremost upon recognizing its purpose. See text at note 123 *infra*.

123. H. REP. NO. 179, 68th Cong., 1st Sess. 21 (1924), quoted in the text at note 16 *supra*.

tainly, in *Cartinhour* it seems that trust income had been used "for [the grantor's] benefit in such a sense and to such a degree that there is nothing arbitrary or tyrannical in treating it as his."¹²⁴

C. The Reciprocal Trust Doctrine

Sometimes there is an effort to couple the tax advantages of creating a trust of insurance on another's life with a de facto retention of powers or financial rights through various devices. In the field of insurance trust, as elsewhere, there is no question that the "real" rather than the nominal grantor of a trust will be treated as the trust owner if, for example, the nominal grantor is but a strawman acting for the "real" grantor, or if the nominal grantor has established the trust in exchange for a bargained for consideration from the "real" grantor.¹²⁵ In terms of insurance trusts, this would follow if, for instance, one paid a third party to take out policies of insurance on one's own life and to transfer the policies together with securities to a funded insurance trust. A somewhat more sophisticated, although now ineffectual, method is to use reciprocal or cross trusts, in which the basic pattern is for A to fund a trust of insurance on B's life, while B, as part of the same transaction (either simultaneously or related in time) funds a trust of insurance on A's life. Since the decision in *Lehman v. Commissioner*,¹²⁶ this or like devices have either been disregarded, or treated as highly suspect by the Commissioner, although the courts currently tend to favor the taxpayer.¹²⁷

124. *Burnet v. Wells*, 289 U. S. 670, 680-681 (1933).

125. These are the two hypothetical examples cited by Judge Hastie in his thoughtful opinion in *Newberry's Estate v. Commissioner*, 201 F. 2d 874, 876-77 (3d Cir. 1953). For an actual case of this sort, see *National Bank of Commerce v. Clanson*, 226 F. 2d 446 (1st Cir. 1955) in which a trust was created for a widow by her family as a part of an agreement where, for business reasons, she released her statutory claim to take against her husband's will. A portion of this trust (of which the nominal grantor was a person other than the decedent) was included under the predecessor of Inv. Rev. Code of 1954, § 2038(a), relating to her gross estate property transferred by a decedent but subject at death to a power to revoke, amend, etc.

126. 109 F. 2d 99 (2d Cir.) cert. denied, 310 U. S. 637 (1940).

127. Virtually all of the reported cases in the courts on the reciprocal trust problem have arisen in the context of whether a trust created by some person other than the decedent should be included in the decedent's estate. However, there seem to be no such peculiarities in the estate tax provisions as would prevent these decisions and their underlying principles being equally applicable to income tax problems as well. The discussion that follows assumes that there is a valid analogy.

The *Lehman* type situation is illustrated by *Purdon S. Whiteley*¹²⁸ holding that the two trusts to be described were reciprocal, and that the taxpayer should be treated, for purposes of income taxation, as the real grantor of a trust created by her brother. There the taxpayer's brother, naming himself as beneficiary, transferred insurance policies on the taxpayer's life to a trust funded by stock and bonds and also by the taxpayer's \$250,000 note on which she paid interest for several years. Two days later, the taxpayer herself created a trust of stocks, bonds, and her brother's \$250,000 note, granting the trustee power to take out insurance on her brother's life. In imputing income of her brother's trust to the taxpayer, the court stressed the fact that "in all material respects the terms of the trusts were identical," and that there was "no other motive for the transaction" than the creation of reciprocal trusts.¹²⁹ Since, therefore, income of the brother's trust had been applied to policies on the taxpayer's life (for her brother's benefit), it was held that this amount was taxable to her, as the real grantor, under old section 167(a) (3).

The precise extent of the *Lehman* doctrine is unclear, and, in any event, cannot be elaborated here. It is apparently undisputed that the trusts need not be identical as to the value of the corpus. Therefore, an insurance trust funded with H's 700 shares and W's 300 shares would be treated as reciprocal to the extent of 300 shares.¹³⁰ Identity of trust provisions seems unnecessary, although doubtlessly increasing divergence of the provisions would suggest that the trusts were not truly reciprocal.¹³¹ Greatest stress seems to lie upon the question whether the trusts were created in consideration of or as *quid pro quo* for each other, since "the fact that trusts contained 'reciprocal' or 'crossed' provisions . . . is significant only to the extent that it may reveal a *quid pro quo* which another than the named grantor has paid for the creation of the trust in controversy."¹³²

128. 42 B. T. A. 316 (1940).

129. *Id.* at 320.

130. In substance, this was the result in *Cole's Estate v. Commissioner*, 140 F. 2d 636 (8th Cir. 1944).

131. As Judge Patterson said in *Lehman v. Commissioner*, "it happened [in that case] that the trusts were identical, and the case for a tax is the stronger for it." 109 F. 2d at 100. There was some disparity in the trust provisions in *Purdon S. Whiteley*, *supra* note 128, but it was treated as immaterial.

132. *Newberry's Estate v. Commissioner*, 201 F. 2d 874 at 877 (3d Cir. 1953).

In *Whiteley*, as in certain other non-insurance trust cases, the element of *quid pro quo* has been so far minimized that the fact of reciprocity alone has almost seemed enough to cast the tax burden upon the "real" grantor of the trust.

Earlier an example was suggested where H created a trust of insurance on his wife's life, for a child's benefit, or on his son's life for the benefit of the son's children.¹³³ To what extent would tax dangers be incurred if the wife, or the son, simultaneously created a trust of insurance on H's life for the benefit of H's wife? Presumably, if it could be shown that "the establishment of 'reciprocal' or 'crossed' trusts was a technical device for realizing the *quid pro quo* of a bargain,"¹³⁴ it would seem that H could be taxed on the income used to keep up policies on his life by the trust created by his wife or son. Treating H as the "real grantor" of those trusts, it would follow that the income had been used, as section 677(a)(3) provides, for "payment of premiums on policies of insurance on the life of the [real] grantor." Although proof within the family circle would ordinarily be difficult, *Whiteley*, if its authority stands unimpaired, comes close to placing the burden of proving no bargain on the taxpayer who the Commissioner claims is the "real grantor."¹³⁵ On the other hand, the likelihood of finding the trusts reciprocal diminishes to the vanishing point with the lapse of time,¹³⁶ the increasing variance of trust provisions,¹³⁷ and affirmative testimony that either one of the trusts would have in fact been created whether or not its opposite number was established.¹³⁸ But this does not alter the fact that interlocking arrangements of this sort have apparently fallen into disfavor because of their somewhat exposed position taxwise, although the more recent Court of Appeals decisions unabashedly favor the taxpayer by very strict and sometimes ridiculous construction of the *quid pro quo* rule.¹³⁹

133. See Section V (A) (2) *supra*.

134. *Newberry's Estate v. Commissioner*, *supra* note 132, at 878.

135. *Purdon S. Whiteley*, 42 B. T. A. 316, 320 (1940).

136. Thus, in *In re Lueder's Estate*, 164 F. 2d 128 (3d Cir. 1947), the Court of Appeals, reversing the Tax Court's finding of reciprocal trusts, held they were not such "as a matter of law" (*id.* at 136), since they had been created, not simultaneously, but more than 15 months apart (*id.* at 134) and there was no evidence of any agreement or understanding that the trusts were consideration for each other (*ibid.*).

137. See note 131 *supra*.

138. Such testimony had a decisive impact in *Newberry's Estate v. Commissioner*, 201 F. 2d 874 at 875, 877-78 (3d Cir. 1953).

139. This attrition of the *Lehman* doctrine that began with *In re Lueder's Estate*, 164 F. 2d 128 (3d Cir. 1947) and which was skillfully ra-

Finally, possible application of the reciprocal trust doctrine must be carefully considered whenever, in planning ahead for a partnership or close corporation, a buy-and-sell arrangement employs funded insurance trusts as a device for financing the purchase of the interest of a deceased partner or stockholder. Similar trusts simultaneously established by the several partners or stockholders may well be considered reciprocal, although this defect seemingly would not apply, for instance, to a single trust created by the corporation itself to finance repurchase of a deceased stockholder's interest.^{139a}

D. Application of Sections 677(a)(1) and (a)(2) to Insurance Trusts

Although a trust of insurance on the life of someone other than the grantor will not entail personal income taxation to the trust's grantor under section 677(a)(3), the tax advantage thus gained may nevertheless be forfeited through the operation of two other provisions of the same section, subsections (a)(1) and (a)(2).

tionalized in *Newberry's Estate v. Commissioner*, 201 F. 2d 874 (3d Cir. 1953) went very far indeed in the decision of the Seventh Circuit in *McLain v. Jarecki*, 232 F. 2d 211 (7th Cir. 1956). There, admittedly similar trusts had been created simultaneously by husband and wife, and thereafter simultaneously amended. The issue was whether the wife's trust should be included in the deceased husband's gross estate. In by-passing *Lehman*, the court considered that it need only "search for consideration moving from the decedent to" the other party. It concluded from the stipulated facts that there was nothing to show that the decedent "brought about the transfer" in trust made by his wife, and refused to "infer an element of consideration" from the fact of the "substantially identical trusts created concurrently and prepared by their mutual lawyers." It appeared to regard "oral testimony" as the only source for determining the "subjective understanding between the parties that will equate to quid pro quo," and that because of the "remote[ness] in time" and unavailability of "oral testimony" as to the intention, there is no basis for treating the trusts as reciprocal for estate tax purposes. The dissent argued — it is believed more realistically — that "[i]t is an undue taxing of our credulity to ask us to believe that this transaction lacked consideration" and that the "only logical inference" was that "the act of one was the consideration for the act of the other."

It should be noted that the Tax Court tends to side with the Commissioner by interpreting the *Lehman* doctrine less restrictively than the more recent court decisions. See *Estate of Florence B. Moreno*, 28 T. C. 889 (1957), *aff'd*, 260 F. 2d 389 (8th Cir. 1958); *Estate of Laura Carter*, 31 T. C. 1143 (1959). It has deflected the force of the judicial rulings by asserting that "the question involved in all reciprocal trust cases is factual" so that "little purpose is served by an extensive discussion of the factual background of each case." *Estate of Laura Carter*, *supra* at 1154, distinguishing *Newberry's Estate*, *supra* note 139 and *McLain*, *supra* note 139.

139a. For an interesting administrative determination, see Rev. Rul. 56-397, 1956, INT. REV. BULL. NO. 34. Here two business associates cross-

1. Section 677(a)(2) (Corresponding to 167(a)(1) of the 1939 Code)

Section 677(a)(2), substantially identical with section 167(a)(1) of the 1939 Code, is the provision most likely to have an immediate impact upon insurance trusts immune from taxation under section 677(a)(3). As it now reads, the section taxes the grantor upon trust income which "is . . . or may be . . . held or accumulated for future distribution to the grantor." The proper interpretation and scope of this provision demands full examination of a large body of law erected upon the 1939 Code section. Its overall objective, however, is adequately illustrated by the simplest sort of fact situation: a corporate executive creates a trust of securities, the income from which is not to be distributed to him during the years when his salary places him in high tax brackets, but is to be retained and distributed to him upon his retirement. If such a device were possible—which it is not^{139b}—much current income tax could be defeated by deflecting the income to a later date when its receipt would presumably be taxed at lower rates. The circumstances which entail section 677(a)(2) tax liability are beyond this article's compass, although, generally summarizing results under 1939 Code cases, a contingent possibility of diversion of trust income to the grantor was enough to result in taxation of the income to him,¹⁴⁰ subject to a limitation of uncertain scope if the possibility of diversion was thought too "remote."¹⁴¹

insured each other's life to provide funds to repurchase the decedent's interest; each retained all incidents of ownership in the policy he owned. The Service held that the decedent's estate need not include, under INT. REV. CODE OF 1954, § 2033, the proceeds which became available to his living associate as a result of the death. Application of the *Lehman* doctrine was rejected on the ground that here, unlike *Lehman*, "the decedent made no transfer of insurance or any other property." Although obviously not involving a funded trust, this ruling may foreshadow an accommodating attitude in this area by the Internal Revenue Service.

139b. It is for this reason that special legislation is needed to defer present income taxation of the income produced by corporation pension trusts. See INT. REV. CODE OF 1954, §§ 401-404, with which provisions precise compliance is necessary to secure tax postponement. Comparable tax accommodation has been vigorously pressed by the self-employed and others who are unable to seek shelter under this section.

140. *Kent v. Rothensies*, 120 F. 2d 476 (3d Cir.), *cert. denied*, 314 U. S. 659 (1941) (accumulation for two years with payment thereafter to the grantor); *Altmaier v. Commissioner*, 116 F. 2d 162 (6th Cir. 1940); *Helvering v. Evans*, 126 F. 2d 270 (3d Cir. 1942); *Wenger v. Commissioner*, 127 F. 2d 523 (6th Cir. 1942).

141. See *Henry Martin Baker*, 43 B. T. A. 1029 (1941) (grantor would acquire the accumulated income only if he survived his wife, his minor son

In a very real sense, purchase of insurance is a type of accumulation of income for future distribution to the beneficiary or to the insured, as the case may be. Indeed, there have been cases under state law on whether insurance purchases are an unlawful accumulation.¹⁴² The operation of section 677(a)(2) upon a section 677(a)(3) immune insurance trust is illustrated by *Commissioner v. Morton*.¹⁴³ There a wife funded a trust to keep up the premiums on \$275,000 face value insurance which she had taken out on her husband's life. So far, this is a straight trust the income from which would not be taxed either to the wife or the husband, but only to the trust itself. The trust indenture gave the husband the sole right to terminate the trust, in which event he would receive accumulated income, the corpus reverting in the wife. Otherwise, three years after his death, the grantor-wife had the sole power to terminate the trust and acquire the corpus. The policies, besides naming the grantor-wife as the beneficiary, also gave her the sole right to the loan and cash surrender values, and the exclusive right to change the beneficiary. The Board of Tax Appeals adhered to its prior decisions that section 167(a)(3) did not come into play even though the trust grantor is the beneficiary of the insurance policies.¹⁴⁴ The court of appeals, however, held

and the son's children); Edwin C. May, 3 CCH Tax Ct. Mem. 733 (1944). But cf. INT. REV. CODE OF 1954, § 677(a), the final sentence of which exempts from the general rule of taxability a power which can take effect upon "the beneficial enjoyment of the income" only after ten years. Cf. Treas. Reg. § 1.677(a)-1(c).

142. Absent statute, it is permissible for a trust to accumulate its income for a period not exceeding that permitted by the rule against perpetuities. 1 SCOTT, TRUSTS § 62.11 (2d ed. 1956). To the extent that purchase of insurance is, as it appears to be, an accumulation, there is no objection on this ground, absent statute, to the trustee's using trust funds for such purposes. The perpetuities period, in the case of insurance trusts, begins to run from the date of the trust grantor's death. 1 SCOTT, TRUSTS § 57.3, at n. 31 (2d ed. 1956). There may be problems, however, as to whether under state law, and absent express authorization, a trustee may invest trust funds in insurance. See Mannheimer & Wheeler, *Trusts of Insurance on Relatives Lives*, 27 TAXES 453, at 458, n. 27 (1949) for a convenient summary of the law on this point.

In some states, accumulations are specifically forbidden by statute. *E.g.*, N. Y. PERS. PROP. LAW § 16. See also 2 SCOTT, TRUSTS § 62.11 (2d ed. 1956). However, at least two cases have held that investment in insurance was not deemed to be a forbidden accumulation under the relevant statute. In the Matter of Hartman's Estate, 126 Misc. 862, 215 N. Y. Supp. 802 (Sup. Ct. 1926) (leading case) which followed *Bassill v. Lister*, 9 Hare 177, 20 L. J. Ch. 641, 15 Jurist 964 (1851). New York has since dispelled all doubt by specifically providing that investment in insurance will not be deemed an unlawful accumulation. See N. Y. PERS. PROP. LAW § 16.

143. 108 F. 2d 1005 (7th Cir. 1940), *rev'd* 38 B. T. A. 419 (1938).

144. 38 B. T. A. at 424, relying upon *Lucy A. Blumenthal*, 30 B. T. A. 591 (1934) and *Gail H. Baldwin*, 36 B. T. A. 364 (1937). See note 114 *supra*.

that the wife, by retaining broad rights under the policies, was, in effect, using her own income, through the medium of a trust, to purchase property for herself in the form of the policies payable only to her at a future date.

It is obvious that the income of these trusts was devoted solely to the grantor's own uses. She was the sole beneficiary of the policies involved in the first trust; she alone had the right to change the beneficiary; she alone was entitled to their cash surrender or loan value . . . [Although] the taxpayer divested herself of the control of the trust estate and of its income, the fact remains that income was expended solely for her own purposes, and the property upon which it was expended, namely the insurance policies, belonged to her and her alone.¹⁴⁵

The court of appeals pointed out that even though "a liberal interpretation of section 167[(a)(1)] might tend to establish the immunity of the grantor from the tax," such a reading was improper in the light of the "practical facts" upon which the court relied.¹⁴⁶

When the benefits under the policies are not as sweeping as in *Morton*, the result will necessarily turn upon the facts,¹⁴⁷ viz. the terms of the trust and policies, the rights retained by the grantor under the policies and, to a lesser extent, under the trust instrument. As expected, the decisions can almost be classified as "liberal" (i.e., favoring the taxpayer) or "strict". Thus, in a leading "strict" ruling,¹⁴⁸ a wife funded an irrevocable trust to carry insurance on her husband's life, with a proviso that the proceeds should pay off any estate and inheritance taxes on the wife's share of her husband's estate should she survive him, but otherwise to be disposed of by her should she predecease him. There was no evidence that the wife retained any other rights under the policies. The fact that the benefit of the insurance was indirect and contingent was deemed irrelevant, for the

Earlier in its opinion the Board had treated the case as a § 166 (now § 676) problem, holding that H's interests in the trust constituted him a party with a substantial adverse interest whose consent was necessary before W could, during H's lifetime, reach the funds which she had placed in trust.

145. 108 F. 2d at 1007.

146. *Id.* at 1008.

147. *Commissioner v. Jergens*, 127 F. 2d 973, 974 (5th Cir. 1942) (dictum).

148. *Phipps v. Helvering*, 124 F. 2d 288 (D. C. Cir. 1941).

income would "be used for her benefit whether her ultimate receipt of it results from a vested or contingent right."¹⁴⁹ Indeed, the statute "is not concerned with whether the taxpayer's right to the income is conditional or unconditional, contingent or vested, for . . . the consideration is not what is done but what might be done thereunder. If there is any possibility that the income of the trust may be received by the grantor, then such income is taxable to the grantor."¹⁵⁰ A similar result was reached in an early Board of Tax Appeals case holding a daughter taxable on funded trust income applied to premiums on her father's life insurance, since she would receive the proceeds on his death.¹⁵¹ The principle of these decisions was strongly affirmed recently by the Tax Court¹⁵² which in previous years had seemed notably reluctant to invoke the accumulation rule against insurance trusts merely because the grantor was a beneficiary of the insurance. Finally, it would seem that taxation would follow if the income from the trust could be used to discharge legal obligations of the grantor.

In *Commissioner v. Jergens*,¹⁵³ the only appellate decision squarely holding the wife *not* taxable under section 677 (a) (2) dealing with circumstances of this character, the wife, according to the sketchy statement of facts in the opinion, "could never receive anything from accumulations or the proceeds of the insurance."¹⁵⁴ In addition, she had renounced cash and loan values of the insurance, had made the trust terminable only by her husband, and could withdraw the policies only with his consent.¹⁵⁵

To the extent that a recent Tax Court ruling can better indicate the state of the law than an eighteen year old court of appeals decision, the 1959 *Estate of Edward H. Wadewitz*¹⁵⁶ case seems almost squarely contra to *Commissioner v.*

149. *Id.* at 292.

150. *Commissioner v. Willson*, 132 F. 2d 255, 257 (6th Cir. 1942); see also *id.* at 258.

151. William Lea Taylor, 37 B. T. A. 875 (1938).

152. Edward H. Wadewitz, 32 T. C. 538 (1959), discussed in the text *infra* at note 156. An older decision in accord is *Commissioner v. Van Dusen*, 138 F. 2d 510 (6th Cir. 1943) (*per curiam*), *cert. denied*, 321 U. S. 776 (1944), *reversing* Charles B. Van Dusen, P-H B. T. A. Mem. Dec. ¶ 42,356 (June 20, 1942).

153. 127 F. 2d 973 (5th Cir. 1942), *affirming* an unreported Tax Court decision.

154. *Id.* at 975.

155. *Id.* at 974.

156. 32 T. C. 538 (1959).

Jergens. In *Wadewitz*, a husband and wife followed the typical two-donor trust scheme, with H contributing \$90,000 of his life insurance and W furnishing the funding securities. W and two children were named as trustees. W was also the beneficiary, and following H's death was to receive a fixed income for life with the remainder over to the children. Since the trustees had "all right, title, interest, and benefits in such policies"¹⁵⁷ as were assigned to them, it is apparent that during her life, W did not have cash surrender and loan rights under the policies. Thus, she evidently had no greater rights than the widow in *Jergens*, having only a hope of the insurance after the insured's death. The Tax Court held that the trust income was accumulated for future distribution to W who should accordingly be taxed on it. Indeed, "there can properly be no question"¹⁵⁸ that the income fell within section 677(a)(2)'s predecessor, section 167(a)(1). This case comes close to holding as a matter of law that any trust grantor who funds a trust of insurance on another's life where she is the beneficiary will be subjected to tax on income under section 677(a)(2). The phrase, "matter of law," seems accurate, since the case did not turn upon any retained rights under the insurance policies or other special facts, but solely upon the finding that the trust grantor was the insurance beneficiary. The only dispute was with the fact that W must survive H in order to acquire the benefits under the policies, and this contention the court dismissed on well settled principles that accumulations need not be unconditional to invoke section 677(a)(2).¹⁵⁹

Collectively, these cases, and especially *Wadewitz*, indicate the extent to which section 677(a)(2)'s accumulation provisions narrow the area of choice for insurance trusts even of policies on the life of someone other than the grantor. They show that for the grantor to avoid personal taxation, the trust must not only confine the policies to those on the life of someone other than the grantor, but also it must restrict to an undetermined extent the benefits which the grantor may retain, present or future, under the policies and the trust. Thus again, non-tax considerations as to the

157. *Id.* at 539.

158. *Id.* at 541.

159. Particular reliance was placed on *Kent v. Rothensies*, 120 F. 2d 476, 478 (3d Cir. 1941), *cert. denied*, 314 U. S. 659 (1941).

desirability of a grantor's renouncing substantial incidents of control over the policies is thrown into high relief. These results may be eased to some extent by the trust of insurance on the life of some person other than the grantor, with third persons named as beneficiaries, and with powers and rights allocated among them. An example of this is naming children as beneficiaries of a husband's trust of life insurance on his wife. As we shall see later,¹⁶⁰ this scheme may, in turn, raise problems of its own as to whether the wife or the children will be taxed on the trust income applied to the policies for their benefit. In sum, these decisions and the doubts they raise still seem viable, since section 677(a)(2) does not materially change the language of its statutory predecessor nor limit its application as developed under the 1939 Code.

2. Section 677(a)(1) (Corresponding to Section 167(a)(2) of the 1939 Code)

A less important limitation upon section 677(a)(3) immunity for insurance trusts of another's policies inheres in section 677(a)(1), formerly section 167(a)(2) which taxes the grantor where trust income "is . . . or may be distributed to the grantor." Such a problem may arise if the trust instrument, besides authorizing premium payments on another's life insurance, leaves open the possibility that the funds for that purpose might be paid over to the grantor. Thus, in *William Clark Arkell*,¹⁶¹ a father contributed policies on his own life to a trust funded by his son who, as trustee, "had the discretion to act in such a way as to avoid at any time the necessity of paying additional premiums and thus gain the income for himself."¹⁶² Trust income was applied to the premiums, and although section 167(a)(3) concededly did not apply, the Tax Court held that the entire trust income "may be distributed to the grantor," and although not so distributed, should therefore be taxed to him. This problem seems one which could be readily solved by specific stipulation

160. See *infra* at Section VI (B).

161. 38 B. T. A. 177 (1938). Cf. *Alfred Cowles*, 6 T. C. 14 (1946) (beneficiary may demand entire net income of the trust; trustees could take out insurance on beneficiary's life, paying premiums from the income. Held: Beneficiary taxable under old § 22(a) on the amount of income used for such a policy). The same decision would probably be made in *Cowles* under § 678(a)(2).

162. 38 B. T. A. at 181.

that the trust income could not be paid over to the grantor under any circumstances, or that it must be paid to named third persons if not used for the insurance premiums.

E. *The "Good Faith" Limitation as Applied to Insurance Trusts Not Taxable Under Section 677(a)(3)*

1. Transfer by Nominal Grantor of Securities to Fund Trust

Besides the various pitfalls already enumerated, efforts to reduce personal income taxation through trusts of insurance on the life of someone other than the grantor have faltered and failed because of the imprecise judicial doctrine which requires "good faith" in the insurance trust transaction.

The first case illustrating the operation of this general limiting principle involves efforts by an insured, the "real grantor," to secure the benefits of trusts of insurance on his own life without incurring section 677(a)(3) personal income tax liability. He transfers the securities to another person, the "nominal grantor," who then, apparently "voluntarily," funds the trust containing policies on the transferor's life. Under this scheme, it is hoped that the "real grantor" will escape all income tax liability under established principles, and that the "nominal grantor" will not personally be taxed since the transferred policies insure some life other than that of the "nominal grantor." When such a scheme fails, the effect is to treat the arrangement as merely a straight trust of insurance on the life of the "real grantor" who is then taxed under section 677(a)(3). This result does not depend upon statutory construction, but upon judicial conviction that the "real grantor" seeks to do indirectly what he is barred from doing directly. It is this factor, then,—the presence or absence of "good faith"—that distinguishes this situation from the *Cartinhour* case which obviously assumed that the two-grantor funding arrangement upheld there was carried through in "good faith."^{162a}

The failure of a "bad faith" device is well illustrated by the strong fact situation in the leading Tax Court decision of *Lorenz Iversen*.¹⁶³ Here the taxpayer created an unfunded trust of \$1,000,000 face value life insurance on his own life, naming his wife and children as beneficiaries, and conferring

^{162a}. See Part V (B) (2) *supra*.

¹⁶³. 3 T. C. 756 (1944).

upon the trustee all other rights under the policies. Two months later, the taxpayer's children funded a trust of securities worth nearly \$500,000 which the taxpayer had given them for that purpose. Since the evidence did not indicate that the taxpayer intended to transfer these funds without limitations, he was deemed to be the real grantor of the trust established with the funds, and therefore taxable on the income used for the life insurance premiums.

If, on the other hand, there has been an absolute and unqualified transfer of funds, the fact that those funds subsequently find their way into a trust of insurance on the life of the transferor of the funds will not subject him to taxation. As the court said in *Rockwell v. Granger*,¹⁶⁴ holding the transferor not liable to tax on funds used for his insurance, "[t]his insurance and bonds the [taxpayer] gave to his wife without any condition, limitation or qualification whatever," and the trust which she established with the funds "was created without any agreement or control or direction of the [taxpayer]."¹⁶⁵

Such a saving factor is not automatically established by showing that title to the securities (or other funds or property) passed to the one creating the trust;¹⁶⁶ it also requires a showing that the transferor did not continue to exert any "control" over the use and disposition of the funds.¹⁶⁷ This means that transfer of the securities to a trust of the transferor's life insurance, or the use of the income to pay the premiums on such insurance, must truly be "voluntary" on the part of the new owner of the funds. The cases, without specifically so declaring, point unmistakably to the burden resting upon the individual who the Government contends is the "real grantor,"¹⁶⁸ in this situation, the transferor of the securities. This burden may be a heavy one when the transactions are within the family, and especially between a husband and wife, for then they "must be closely scrutinized to determine their real character."¹⁶⁹ This indicates that

164. 62 F. Supp. 907 (W. D. Pa. 1945).

165. *Id.* at 909-10.

166. Although, of course, not conclusive, passage of absolute title is a strong factor favoring the taxpayer. See the court's reliance on that in *Rockwell v. Granger*, 62 F. Supp. 907 at 909-10.

167. *Id.* at 910.

168. See *George Washington, Sr.*, 36 B. T. A. 74 at 79 (1937).

169. *Christina G. Lipe*, 3 CCH Tax Ct. Mem. 917 (1944) (*semble*); *George H. Whiteley*, 42 B. T. A. 402, 415 (1940), *aff'd*, 120 F. 2d 782 (3d Cir.), *cert. denied*, 314 U. S. 657 (1941) ("Meeting of the minds of petitioner and his wife has not been negated").

there is no presumption of the existence of the forbidden degree of "control" merely because of the close personal relationship of the individuals involved.

The essential finding that the transaction was in good faith may rest upon evidence of a non-tax motive on the part of the transferor,¹⁷⁰ or upon the fact that tax-wise no sensible person would have adopted that course of action as a means of saving taxes,¹⁷¹ or that the insured takes out the policies clearly at the behest of another person and retains no right to change the beneficiary.¹⁷² Even though documentary evidence might well raise "reasonable suspicions" that the transfer was exclusively tax-motivated and therefore not in "good faith," this may be rebutted by an affirmative showing through oral testimony upon which the trier of fact may conclude that tax objectives were not primary.¹⁷³ Finally, while tax objectives may suggest "bad faith," it seems perfectly clear that a sophisticated recognition of the tax consequences of alternative transactions and the selection of the one entailing minimum personal tax liability will not of itself vitiate the transaction, if otherwise it appears to be bona fide. All in all, it is "wholly a question of fact"¹⁷⁴

170. George H. Whiteley, *supra* at 409. Thus, in *Rockwell v. Granger*, *supra* note 169 the husband-transferor's objective was to provide for his wife after he had experienced severe financial reverses in stock trading, (*id.* at 909), and this was strengthened by his complete divestment of all control of or interest in the transferred securities (*id.* at 910). Similarly, in *Christina G. Lipe*, 3 CCH Tax Ct. Mem. 917 (1944), her object, established by oral testimony, was a sense of "moral obligation" to distribute funds inherited from her deceased husband as he had requested, coupled with the fact that the funds thus transferred were far more than needed to maintain the premiums on the life insurance subsequently taken out on her life by her daughters, the transferees. *Id.* at 918-19.

171. "If her motive was primarily, or even substantially, that of tax avoidance by the creation of trusts for the purpose of paying for insurance upon her own life, she chose a most expensive method to accomplish it. We think it unlikely that her gift sprang from any such motive." *Christina G. Lipe*, *supra* note 170, at 919. Although a taxpayer is "extremely tax conscious, as shown by various transfers and retransfers of property between the [taxpayer] and his children in prior years," his transactions will not be automatically nullified for tax purposes, at least where it does not appear that "those transfers were made merely to reduce income tax." George Washington, Sr., 36 B. T. A. 74 at 79 (1937). In *Lucy A. Blumenthal*, 30 B. T. A. 591 (1934), the Board noted the Commissioner's argument that the trust of insurance on the life of some person other than the grantor would fail because of "a controlling purpose to reduce or evade taxes" (*id.* at 595), but did not decide the issue since the record was found devoid of evidence of such a "controlling purpose." Seemingly, the test would not be met merely on a showing of no more than a subjective tax reduction motive, but would probably require some indication that the scheme was, viewed objectively, unreal or a sham.

172. *Christina G. Lipe*, *supra* note 170, at 919.

173. *Id.* at 918.

174. *Ibid.*

whether the transfer is, from a tax standpoint, merely colorable or in good faith.¹⁷⁵

If in these and like cases, the transaction is skillfully handled with due regard to formalities, and if it has some independent justification, there is a good chance of obtaining the desired result. This is excellently demonstrated by *Central Hanover Bank & Trust Co. v. Hoey*¹⁷⁶ where the result favoring the taxpayer depended almost entirely upon careful drafting of the instruments, conformity to their terms, and an independent non-tax justification.¹⁷⁷ There a father had established three very large irrevocable security trusts for his son, giving him a power to encroach on the corpus at his discretion.¹⁷⁸ Exercising this power, the son in substance terminated the old trusts, obtained their funds, established new trusts with the funds, and transferred to those trusts a number of policies on his father's life. The court held, interpreting the trust provisions and the surrounding circumstances, that the new insurance trusts had been in fact, and not colorably, created by the son, and that the income applied to the father's policies could not be taxed to him on a theory that he was the real grantor. This result followed despite a showing that an obvious purpose was to reduce the father's extremely high-bracket taxes.

Obviously, the application of any standard of "good faith" must and will be determined upon the facts of the individual case. For this reason, the transfer of funds within a closely-knit group followed by establishment of a trust, the income

175. In *George H. Whiteley*, note 169 *supra*, the tax scheme so strongly suggested tax evasion that it failed altogether. There, a taxpayer, ostensibly acting under the guidance of financial advisers who had taken over his affairs following disastrous stock trading losses, had, in effect, taken out policies on his own life and placed them in an unfunded trust. He also executed a note, again in connection with straightening out his financial affairs, to his wife who funded the insurance trust with the note and with some of the taxpayer's securities. Although there was evidence that he had objected to the plan, the court found that the real purpose was to carry insurance on his life, and that there was evidence of a mutual understanding that the trust arrangement was for his benefit. He was held taxable under § 677(a)(3)'s predecessor for the income used for the insurance premiums.

176. 74 F. Supp. 770 (S. D. N. Y. 1947).

177. In *Central Hanover* this was shown by the fact that the son "needed" funds, available only through encroachment and not through any of the other powers he held under the old trusts, for his forthcoming marriage.

178. Today, the reservation in the son of the power to encroach the old trusts would raise serious problems as to his taxability under § 678(a)(1), although, for a very high-bracket taxpayer, such as the original grantor, it would, on balance, be more beneficial for the presumptively lower-bracket son to bear the tax.

from which would be taxed to the high-bracket taxpayer had he created the trust himself, entails a very considerable risk of taxation, and an almost complete certainty of contest by the Commissioner, both administratively and in the courts. Such Government strictness is to be expected, and is desirable, for the risk of tax evasion is exceedingly great, and the determination of good faith very difficult. Doubtlessly, the disfavor of such transactions, and the threat of contest, is designed to steer persons away from tax devices which have so high a potentiality of misuse. The success of the *Central Hanover* case, both as a matter of statistics and of principle, is most unusual.

2. Payment of Premiums by Beneficiary of an Income Trust

The second category of cases—to which many of the observations above apply equally—involves the payment by A of premiums on B's insurance, out of A's personal funds, often received from a trust established by B. When this pattern exists within the family, *e.g.*, B and A are respectively husband and wife, it too will likely incite a claim by the Government that it is a colorable device for B to escape section 677(a)(3) income taxation on the funds used for his premiums. Viewed collectively, the cases establish that if the trust instrument does not empower the trustee to pay the premiums, and, most important, if there is no evidence that the grantor controls or directs the beneficiary's use of the income, the grantor will not be liable for tax if the beneficiary should decide to spend the income on insurance on the grantor's life.

It is not clear how significant is the *absence* from the trust indenture of a provision empowering the trustee to apply trust income to the grantor's policies. It was negatively significant in one case¹⁷⁹ holding a grantor not taxable, but since that case largely rested on the absence of "control" in the beneficiary's use of the trust income for the grantor's policy premiums, it may be supposed that it would weigh little in the scales if evidence exhibited the forbidden measure of "control." But, presumably, it does yeoman's work in a case otherwise supported by evidence of the beneficiary's voluntary action. Here, as elsewhere, the trustee's power to apply trust income to the grantor's insurance should be

¹⁷⁹ *Frederick K. Barbour*, 39 B. T. A. 910 at 913 (1939), *rev'd on other grounds*, 122 F. 2d 165 (2d Cir.), *cert. denied*, 314 U. S. 691 (1941) (leading case).

mitted from the trust instrument unless there is good reason to insert it.¹⁸⁰ Its *presence*, followed by a beneficiary's use of the trust income, would probably invite litigation, which would be successful unless there was very clear evidence of the "voluntary" character of the beneficiary's action.

The critical problems are forced into the notion of "controlled" versus "voluntary" action by the beneficiary. The synonyms so often used are scarcely more revealing than the terms they purport to explain, and, as usual, this merely points to the fact that the determination is, in large measure, one of informed intuition as to the totality of facts and circumstances in the case. Certainly, if there is any requirement or compulsion, legally enforceable or otherwise, upon the beneficiary, the grantor is taxable.¹⁸¹ The same is true on a showing of "agreement" or "understanding," as it is also on evidence that the grantor "suggested" and the beneficiary "acquiesced" in the beneficiary's payment. In addition, whether or not the beneficiary rather than the grantor, owns the policies which the beneficiary is supporting, seems to be an important factor within the case law on this subject.¹⁸² On this distinction, the Tax Court concludes that if the policies are owned by the grantor, the beneficiary's payments are a substantial economic benefit to the grantor; whereas in the contrary case, the benefit is all to the beneficiary who may find that this exposes him to taxation under section 677(a).¹⁸³ Moreover, other factors may be significant, *e.g.* (a) whether the grantor or the beneficiary took out the policies and paid the initial premiums; (b) the facts surrounding the beneficiary's decision to use the funds for that purpose on a long term basis, so that the Tax Court may conclude simply that "[i]t was her income as beneficiary of the trust already established for her by [the taxpayer] that was involved in the decision" to pay the premiums;¹⁸⁴ (c) the fact that the beneficiary, prior to the creation of the trust whose income she applied to the policies, may have been paying premiums on the policies, and that independently of the

180. See note 98 *supra*.

181. Frederick K. Barbour, *supra* note 179, at 913; L. B. Foster, 8 T. C. 197 at 205 (1947); Stephen Hexter, 47 B. T. A. 483 at 490 (1942).

182. Frederick K. Barbour, *supra* note 179.

183. Henry A. B. Dunning, 36 B. T. A. 1222, 1230-31 (1937), *appeal dismissed*, 97 F. 2d 999 (4th Cir. 1938), distinguished in Frederick K. Barbour, *supra* note 179 at 914, Stephen Hexter, *supra* note 181, at 490, and George F. Booth, 3 T. C. 505 at 611 (1944). See Part V (D), *supra*.

184. George F. Booth, *supra* note 183 at 611.

trust she had funds to continue doing so. This, indeed, would be so "even if we assume that trust income paid the premiums."¹⁸⁵

Inferences of "control" may be obvious or subtle. The emphasis upon the grantor's "suggestion" must be taken, as the cases show, not to be decisive in itself, but only as an indicium of "control." But "control" does not follow even if it "can be said . . . that the wife's course of action met with her husband's approval," for "[i]t is difficult to believe that this could have been done without the consent and approval of the husband. Yet . . . that voluntary and undirected conduct of the wife [has not] resulted in attributing trust income to the grantor husband, particularly where the income is as clearly the unqualified property of the wife as it is here."¹⁸⁶ But the grantor was held taxable where evidence showed that his wife paid the premiums from a savings account which received the trust income and which "was opened principally for" receiving the trust income, had no other deposits, and was used to pay the premiums. Far from being available for the wife's "unfettered use and enjoyment," this was an "arrangement for paying premiums . . . to make it appear that they were being paid out of the wife's own funds rather than out of trust income."¹⁸⁷

These cases indicate that "voluntary" payments by a trust beneficiary of the premiums on policies of insurance on the life of the trust grantor will be sustained if the beneficiary owns the policies. If the trust grantor owns the policies, payments will likely be taxed to him if the slightest evidence of "control" is present, as in *Dunning*.^{187a} Absent the "control" factor, a situation not yet clearly determined, it would seem likely that a voluntary disposition of the funds, already taxed to the beneficiary at presumably lower tax rates, would not result in taxation to the grantor when used to pay the pre-

185. Stephen Hexter, *supra* note 181 at 490; compare Henry A. B. Dunning, *supra* note 183, at 1231.

186. George F. Booth, *supra* note 183 at 611-12.

187. L. B. Foster, 8 T. C. 197 at 206 (1947), *acq.* 1947-1 CUM. BULL. 2. See also the patent tax avoidance scheme, unjustified by other considerations, in Edward E. Rieck, 41 B. T. A. 457 (1940), *aff'd* 188 F. 2d 110 (3d Cir. 1941). There, a trustee, empowered to borrow money to pay the taxpayer's life insurance premiums, called for the income beneficiaries to pay up the premiums when the trust income was short. However, at the end of the year, when he distributed income, he did not deduct the amount of the loans or otherwise seek to collect on them. The Board of Tax Appeals held that the funds thus advanced were really loans to be restored from income, and that trust income had been applied to the grantor's policies.

187a. See note 183 *supra*.

miums on his life insurance policies, particularly where he has renounced rights and powers under those policies. On the whole, the decisions noticeably turn to a larger degree than usual upon the evidence, especially that bearing on the "control" aspect. Appropriate planning by one cognizant of the pitfalls may permit achievement of desired goals without the impact of undesired taxation.

VI. TRUSTS OF INSURANCE ON THE LIFE OF A PERSON OTHER THAN THE GRANTOR: OTHER POTENTIAL GROUNDS OF TAXATION TO THE GRANTOR

A. *Taxation of Insurance Trust Income to the Trust Grantor Under the "Clifford" Provisions of the Internal Revenue Code (§§671-676)*

The cases which have been discussed show that although trust income applied to insurance on the life of someone other than the grantor will avoid direct taxation of that income to the grantor under section 677(a) (3), it may nevertheless be taxable under section 677(a) (1) and 677(a) (2) if the grantor has reserved broad powers and rights or may acquire them under the trust or the policies. These sections, however, are not the only ones which may expose the grantor to tax despite his insulation from section 677(a) (3)'s impact.

Prior to the 1954 Code, it was settled that the grantor of an insurance trust, immune under section 677(a) (3)'s predecessor, might be taxed under the broad definition of "income" in section 22(a) of the 1939 Code (now section 61 of the 1954 Code), if he had reserved various indicia of control such as powers to revoke, alter, or amend the trust, vote equity securities funding the trust, withdraw them from the trust, control the application of trust income, or had retained a possibility of reverter. These and like elements of "control" were decisive in the landmark decision of *Helvering v. Clifford*¹⁸⁸ which rested squarely upon section 61's predecessor, section 22(a) of the 1939 Code, the broad governing

188. 309 U. S. 331 (1940). "Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus" for purposes of § 61's predecessor. 309 U. S. at 336.

principle of which could equally apply to insurance trusts as well as to other types of trusts. The effect of the *Clifford* ruling was to "shift nearly all trust income tax litigation to that section [61's predecessor]"¹⁸⁹ until 1954 when (1) the *Clifford* doctrine, previously intermediately formalized in Treasury Regulations,¹⁹⁰ was Congressionally codified in 1954 Code sections 671-678, and (2) recourse to section 61 for further "common-law" growth along the lines indicated by *Clifford* was largely blocked by section 671.¹⁹¹

The *Clifford* and related rules are codified in subpart E of the Code, comprised of sections 671-676 and 678, in addition to section 677 which has been examined in detail. Without exhausting the multitude of possibilities in these provisions, we shall look to a few examples under each section to show how an insurance trust, not falling within any of section 677's provisions, may nonetheless entail taxation of the trust income to the grantor. In these examples, for the sake of simplicity, we assume that a wife has funded a trust of income-producing securities and insurance policies on her husband's life under "good faith" circumstances precluding application of any subsection of section 677 so as to make the grantor-wife taxable.

1. Section 673: Reversionary Interests

If the trust specifies that within ten years or sooner the wife creating the trust has a reversionary interest either in corpus or income, she will be subject to personal taxation upon the trust's entire income, and not just the income which is or may be applied to the insurance premiums.¹⁹² A reasonable probability of such a reversion is sufficient to evoke the result, if she retains a reversionary interest in the securities. An example of this is where a wife creates

189. SURREY & WARREN, *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 820 (1955 ed.).

190. Treas. Reg. 118, § 39.22(a)-21. Criticism and defense of these regulations, now academic, centered on whether the Treasury had improperly selected certain factors as singly decisive of grantor taxation, in view of the *Clifford* case's emphasis upon the aggregate impact of a number of factors. SURREY & WARREN, *op. cit. supra* note 189, at 828. Commissioner v. Clark, 202 F. 2d 94 (7th Cir. 1953) held the regulations unconstitutional, and even questioned the power of Congress to enact the content of the regulations in statutory form, thus impliedly throwing doubt (although hardly a substantial doubt) upon the validity of § 671-678.

191. See Part VI (C) *infra*.

192. More precisely, upon the income attributable to that portion of the trust (which may be a part of the entire trust) in which the grantor holds a reversionary interest.

a trust of insurance upon an unwell or aged husband. Taxation to the grantor can be avoided (1) by not preserving a reversionary interest, and, to make doubly sure, by explicitly negating any possibility of reverter by making the trust ultimately payable to a charitable institution,¹⁹³ or to a government; (2) by granting a reversionary interest to some person other than herself.¹⁹⁴ On the credit side, a more-than-10 year reversionary interest will not expose the grantor to taxation, and as the time for its expiration approaches, it may safely be extended for an additional like period of time, without thereby creating tax liability to the grantor.¹⁹⁵

It should also be noted that while the mere existence of the grantor's reversionary interest may not bring the trust within section 673, the income produced by that trust may, as Regs. § 1.673(a)-1 point out, be treated as accumulated, and the grantor taxed under section 677(a) (2). This would be the case where W sets up an insurance trust to fund policies on H's life, and the insurance proceeds are payable to the children on H's death with the trust corpus reverting at the same time to W. If the trust income has exceeded the amount of the premiums and this excess ploughed back into the corpus, it would appear to be a clear section 677(a) (2) accumulation for W.

2. Section 674: Powers to Control Beneficial Enjoyment

If the wife in our example reserves a power to determine whether trust income shall be applied to premiums on her husband's policies or allocated among her adult children, she will be subject to taxation under section 674(a). The prior consent of an adverse party will, of course, immunize her, *e.g.*, if the beneficiary of the insurance must first consent to the diversion of trust income to the use of her children. The excepted powers under section 674(b), which any person may exercise, seem ordinarily inapplicable to insurance trusts as such.¹⁹⁶ It is arguable, however, that the power of in-

193. INT. REV. CODE OF 1954, § 673(b).

194. Possible tax consequences to this person are considered in the discussion at Part VI (B) *infra*.

195. INT. REV. CODE OF 1954, § 673(d).

196. That is to say, that these powers, and their tax consequences, would ordinarily come into play when retained with respect to the securities funding the trust. Thus, if a power retained with respect to the funding securities is "exercisable only by will," it would seem that the grantor would

dependent trustees under section 674(c)(1) to "distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries" may embrace a power to divert income for current distribution to one beneficiary into insurance on a life other than the grantor for the benefit of another named beneficiary. If the trust income were solely for that purpose, it could not be taxed to the grantor. It seems that an independent trustee's discretion to use trust income for the same purpose would be permissible, and not in conflict with the obvious purpose of section 674(c) which allows broad discretion in an independent trustee without attendant risk of personal income tax liability on the grantor. Moreover, such diversion of income would be a distribution or accumulation of income within a class of beneficiaries. Finally, such application of income would seem, in view of the decisions under section 677(a)(2) treating trust income applied to certain policies as an "accumulation" for the grantor's benefit, to be an accumulation of income for a beneficiary properly exercisable by the independent trustee.

3. Section 675: Administrative Powers

The administrative powers covered by section 675 apparently apply with as much force to insurance as to other trusts. Thus, a grantor who could borrow or deal with the trust corpus otherwise intended to fund policies on another's life would equally be treated as an owner of that portion of the trust. General powers of administration¹⁹⁷ could be exercised by the grantor if, in so doing, he acts in or with the consent of one who is in a fiduciary capacity as to the trust, *e.g.*, voting stock, controlling investments, etc. As to certain powers, the grantor may safely act only with the permission of an adverse party. This provision codifies the result in *William J. Garland*¹⁹⁸ where the Tax Court held revocable, in effect, a trust which purported to be irrevocable but from which corpus the grantor could borrow (up to \$100,000)

not be liable for income tax on the trust subject to that power. See INT. REV. CODE OF 1954, § 674(b)(3). Similarly, a retained power to distribute the securities funding the insurance trust to or for a beneficiary under "a reasonably definite standard which is set forth in the trust instrument" would not subject the grantor to income tax in the case of an insurance trust any more than in an ordinary trust. INT. REV. CODE OF 1954, § 674(b)(5)(A).

197. INT. REV. CODE OF 1954, § 675(4).

198. 42 B. T. A. 324 (1940), *subsequent opinion rendered*. 43 B. T. A. 731 (1941).

without security. Like a grantor's power to purchase assets at his own price, the borrowing power "renders the trust revocable under section 166 of the Revenue Act of 1934" (now section 676).¹⁹⁹ This type of decision builds a helpful bridge between section 675 and section 676.

4. Section 676: Power to Revoke

Finally, section 676, relating to a grantor's retained "power to revest . . . title" in himself, obviously is applicable to an insurance trust where the grantor may recapture the securities funding the trust, although section 676(b) makes this provision parallel with section 673's ten-year provision as to reversions. As with that section, a less than 10 year power to revoke will subject the grantor to taxation on the entire income, and not just that applicable to premiums. The Treasury Regulations under section 676 broadly treat the term "power to revest" as inclusive of a power to revoke, terminate, alter, amend, or appoint, provided that it amounts to a power of revestment.²⁰⁰ Thus, the early case of *DuPont v. Commissioner*,²⁰¹ involving three-year revocable trusts on the grantor's life insurance, could today be decided solely on the ground of a power to revoke the corpus subjecting the grantor to tax on the total income, and not just that applied or applicable to his insurance premiums. The power to revoke may, for tax purposes, be neutralized by the required consent of an adverse party.

In *William J. Garland*,²⁰² the Tax Court held, as an apparent alternative, that revocability, in the case of an insurance trust, could be inferred from the grantor's sole right under the indenture "to receive all payments, dividends, surrender values, and benefits accrued or which may accrue to the insured during his life, and may exercise all of the insured's rights, options and privileges under such policy." The reservation of these rights is tantamount to a reservation of the right to revest in the trustor that part of the corpus which consisted of insurance policies.²⁰³ The fact that the policies were on the grantor's life²⁰⁴ seems merely incidental to the decision, and the Tax Court apparently so believed

199. *Id.* at 328; 43 B. T. A. at 735.

200. Treas. Reg. 1-676(a)(1).

201. 289 U. S. 685 (1933).

202. 42 B. T. A. 324 (1940).

203. *Id.* at 329.

204. *Id.* at 326.

since it made no reference to section 677(a)(3)'s predecessor, as it could have if it had thought this characteristic of the policies to be significant. The fact is that like powers could be held on the policies on another's life with the grantor-insured possessing nearly equal economic benefits. The *Garland* case, as expected, also resulted in taxation of the entire trust income to the insured-grantor. The case certainly seems to warn that trust income applicable to policies subject to such control by the grantor may be taxable to the grantor on the theory that these powers constitute de facto a power to revest.

*B. Section 678 and Taxation of Insurance Trust Income to Some Person Other Than the Grantor of the Trust:
The "Mallinckrodt" Doctrine*

For the most part, it has been assumed that if the insurance trust grantor obtains personal income tax immunity, it is the trust itself which will be taxed on income used for premium payments, and at rates significantly lower than the grantor's own tax brackets. For example, in the case of a trust of insurance on some life other than the grantor's, the trust will carry the tax burden on income applied to premiums. In some instances, however, the grantor's personal tax immunity may have the effect of shifting the tax, not to the trust, but to some other individual having an interest in the trust or in the insurance.

1. This is apparent, first of all, in the case of a trust of insurance on the grantor's own life where the grantor is tax immune under section 677(a)(3) since the application of the trust proceeds to the insurance premiums requires the consent of an income beneficiary who could, if he chose, require the income, in whole or in part, to be paid to him rather than used for the premiums, and who is therefore an "adverse party."²⁰⁵ Whatever the use made of the trust

205. Messrs. Mannheimer, Wheeler and Friedman give this as the basic example in their article, *An Unexplored Form of Insurance Trust*, 34 TAXES 494 (1956), already referred to, *supra* at notes 67-68. They also discuss a variant of this basic example which would eliminate taxation to the beneficiary in this type of situation. If the beneficiary does not have a right to demand payment of current income to him, but to "require that the income be distributed to him currently or that it be accumulated for his benefit or the benefit of his estate," he will not be taxed if in addition "the trustee is empowered, in his sole discretion, to decide whether the income is to be so distributed or accumulated." *Id.* at 495. Thus, the son has no power to get income currently "exercisable solely by himself," and

income, the beneficiary is the one taxed, and not the grantor, since under section 678(a) (1) the beneficiary has "a power exercisable solely by himself to vest . . . the income therefrom in himself."²⁰⁶ Requiring the power to be exercised by the income beneficiary in conjunction with some other person would not affect the beneficiary's status as an "adverse party" and would seemingly eliminate his exposure to income tax because of his power over the income. Thus, we have here a simple, convenient, and workable insurance trust *on the grantor's life* with relatively favorable tax consequences. It functions well as long as the beneficiary who might have to bear the tax is in a lower bracket than the grantor, and that is typically the case.

An important point should be noted here. On the surface, it would appear that section 678's tax-switching effect could apply broadly since the person who must "solely" use his power is not described by section 678 as an "adverse party"²⁰⁷ or one acting in a fiduciary capacity;²⁰⁸ indeed, for aught that appears, he might well be a "non-adverse"²⁰⁹ or even a "related or subordinate party."²¹⁰ The prospect of broad tax saving possibilities is illusory, since usually the tax-switching effect will depend initially upon the grantor's powers having to run the gamut of an "adverse party's" prior consent. In the example given in the preceding paragraph, the result turns upon the fact that the income beneficiary is an "adverse party" under section 677(a) (3); if he were merely a non-adverse party, section 677(a) (3) would automatically tax the grantor on the trust income, and no occasion would arise to consider, for purposes of section

so is not taxed on the income; the income applied to the insurance policies likewise does not result in taxation to the son, but to the trust.

A further refinement would employ the basic example, but instead of giving the son the right to demand income currently, he "is given the power to require the trustee — an independent trustee — to distribute the income to any one or more of a class composed of the son and the son's issue." *Id.* at 496. If the son fails to exercise his power so that the income goes to the insurance premiums, there is tax only to the trust and not to the beneficiary.

206. Nor would § 678(b) shift the income back to the grantor. Although the income beneficiary in our example has a "power over income," the very presence of this power in an admittedly adverse party would preclude the grantor from being "treated as the owner under §§ 671-677, inclusive," so that the requirement in the last clause of § 678(b) would remain unsatisfied.

207. INT. REV. CODE OF 1954, § 672(a).

208. *Cf.* INT. REV. CODE OF 1954, § 675(4).

209. INT. REV. CODE OF 1954, § 672(b).

210. INT. REV. CODE OF 1954, § 672(c).

678(a)(1), the character of the "person other than the grantor."

Before passing to the next examples, we should first call attention to a point applicable to insurance and also to other types of trusts. It is the determination of who shall bear the income tax when both the grantor and some "person other than the grantor" might reasonably be taxed. Section 678(b) provides a limited, and useful, statutory solution. It declares, in effect, that whenever both the grantor or the other candidate for the tax may be treated as "owner" of the trust or some portion of it, the conflict will be settled in favor of taxing the grantor. Thus, given a trust of insurance on the grantor's life, *prima facie* exposing him to section 677(a)(3) tax, the grantor will pay the tax, even though some other person has, for example, a power to demand and receive trust *income* at his will.²¹¹ If it is *corpus* rather than income that is subject to the other person's demand, and both grantor and the other person could be taxed, section 678(b)'s language is inapplicable; section 678(a) controls and imposes the tax upon the other person by virtue of his possession of a power over the trust.²¹² As we have seen, even this subjection to tax can be eliminated if the other person's power is not exercisable "solely" by him.²¹³

211. This would be the case, for instance, if a non-adverse party could acquire the income. If, as in preceding examples, the party who can demand the income is adverse to the use of trust income for the grantor's insurance, the grantor, by the very terms of § 677(a)(3), is tax immune.

212. This would be true even if the holder of a power over corpus were non-adverse. Section 677(a)(3) is not satisfied, because application of trust income to the grantor's insurance policies is not subject to an adverse party's veto. However, the second line of defense is reached: if the power of the "person other than the grantor is as to corpus," § 678(b) declares that it is he, rather than the admittedly otherwise taxable grantor, who carries the tax burden. He could also immunize himself under § 678(a)(1) by conditioning his power over corpus by joint action with another person. Thus, the tax statute seems to open the way for a device of dubious justification: a trust of the grantor's life insurance on which neither the grantor nor an adverse holder of power over the trust corpus can be taxed on the trust income used for the grantor's policies. This certainly seems to circumvent the spirit of § 677(a)(3).

213. Undoubtedly, the courts will not permit a "person other than the grantor" to act collusively with another person, and therefore escape § 678(a)(1) taxation on the ground that his power was not exercisable "solely by himself." This would seem to be true although there is nothing in the statute specifying the type of party whose joint action with the power-holder will save the latter from tax. Certainly, if the other party is a dummy, one could readily say that the "person other than the grantor" is able, in substance, to exercise the power "solely by himself." Indeed, there should be considerable scrutiny and strictness here, since the "solely" limitation has potentialities of a major loophole through purely formal arrangements. Courts would seem justified in allocating the burden of

Hence, if the power is over corpus, in practice the only question will be the taxability *vel non* of the "person other than the grantor."²¹⁴

2. Let us examine the two-grantor trust in the light of these principles. Here, typically, W contributes income-producing securities to fund a trust to which H contributes insurance policies on his own life payable to W on H's death. H is not taxed under the applicable precedents, since one who contributes only policies to a trust has not as yet been treated as the "grantor" of the trust for section 677(a) (3) purposes.^{214a} W (who funded the trust) is not taxed under section 677(a) (3) since the income does not go to policies on the grantor's life, although the possibilities of taxation under section 677(a) (2) for an accumulation for the grantor's benefit are now increased with the *Wadewitz* decision.²¹⁵

Suppose that under the trust instrument H is given a power to acquire the corpus of the trust, *i.e.*, the funding securities. As to this power, H would be taxable upon the entire trust income under the *Mallinckrodt* doctrine,²¹⁶ now codified as section 678, since he has a "power exercisable solely by himself to vest the corpus" of the trust in himself. Two consequences now follow: (a) if the power must be exercised only in conjunction with some other person,

proving the genuineness of the joint action to the person seeking to escape tax by asserting that he had no "solely" exercisable power.

214. We say "in practice," since the "person other than the grantor" will usually have the requisite power under § 678(a) because he will have sufficient beneficial interest to be an "adverse party" whose prior consent is necessary to prevent grantor taxation under § 677(a) (3). The possibility that the "person other than the grantor" will not be taxed arises, of course, from the device of requiring him to exercise his power with another person.

214a. See Part V (B) (2) *supra*.

215. Edward H. Wadewitz, 32 T. C. 538 (1959). See the text at notes 156-59 *supra*.

216. So-called from Edward Mallinckrodt, Jr., 2 T. C. 1128 (1943), *aff'd* 146 F. 2d 1 (8th Cir.), *cert. denied*, 324 U. S. 871 (1945). Here, a son had power to demand payment to him of income of a trust created by his father. Absent such request, the income was added to corpus which the son could appoint by will. The court held the son taxable on the income under the predecessor of § 61. See also *Emery v. Commissioner*, 156 F. 2d 728 (1st Cir. 1946); *Spies v. United States*, 180 F. 2d 336 (8th Cir. 1950); *Bunting v. Commissioner*, 164 F. 2d 443 (6th Cir. 1947), all holding taxable under § 61(a)'s predecessor trust income available to persons other than the grantor. The *Mallinckrodt* doctrine was thereafter restated by the Internal Revenue Service in expanded form in the so-called "Mallinckrodt Regulations." Treas. Reg. 118, § 39.22(a)-22. Section 678 of the 1954 Code, of course, now provides the statutory base. It should be noted that the *Mallinckrodt* and *Clifford* decisions, and their subsequent progeny, rest on precisely the same rationale, that is, treating as the true trust owner the person who has the actual control of the trust, and therefore taxing the trust income to him personally.

e.g., an independent trustee, section 678(a) is inapplicable, and H is not taxed on the trust income; (b) more importantly, it would seem that W is now insulated from the possibility that the trust income used for insurance payable ultimately to her will be taxed to her under section 677(a) (2). The reason is that the normal tax-switching effect under the "general rule" of section 678(a) is inapplicable if the "person other than the grantor" has a "power over income" and yet the trust grantor would "otherwise [be] treated as owner" of the trust under some other provision. That is to say, if H could demand the *income* of the securities while W is subject to tax under section 677(a) (2) for accumulating income for herself, it is W, and not H, who will be taxed. If H can demand the *corpus*, section 678(b)'s "exception" is inapplicable, and the general rule of section 678(a) would govern. If H can demand corpus only with the trustee's consent, he too is not subject to tax. Since recourse to judicial lawmaking under the general definition of "income" in section 61 (formerly section 22) is now blocked by section 671, there seems no other ground to assert a tax against H in these circumstances.

To vary the example above, suppose H has been given extensive powers under the insurance trust (1) to secure the loan and surrender values of his policies and/or (2) to change the beneficiaries of the insurance trust. As to (1), it would be arguable that this is equivalent to a power to vest at least part of the trust corpus in the holder of the power, since as time goes on the insurance policies, now part of the trust *res*, gain great monetary value. The principles outlined in the preceding paragraph would then apply.

As to (2), it would seem that this is a section 674 power to control beneficial enjoyment at any time, and it may be assumed for purposes of argument that it does not come within any of the exceptions of section 674(b) and (c). Our only interest here is whether H now has, under section 678(a) (2), "such control as would, within the principles of sections 671 to 677, subject a grantor of a trust to treatment as the owner thereof." It would seem that he could not be taxed, even if there were present the requisite degree of "control," since section 678(a) (2) envisions that such "control" is a residue left after the renunciation of a broader power "exercisable *solely* by [the beneficiary] to vest the

corpus or the income therefrom in himself," and by hypothesis there has not been the requisite quantum of power at any time. Moreover, although this is a type of *Mallinckrodt* situation, the codification of that doctrine by section 678 is subject to section 671's limitations so that further "common law of taxation" development or extension of the *Mallinckrodt* doctrine could not be based on section 61's definition of "income." In sum, then, neither H nor W would be taxable on the income used for premiums, but it would be taxed at the trust's low rates.

This example underscores a significant fact about section 678. It is clear that there are limits to the power which a person other than the grantor may retain and yet not find himself treated as owner of a portion of the trust. The statutory test is whether the power, exercisable solely by himself, is equivalent to an ability to "vest the corpus or the income therefrom in himself." It would seem that a power to revoke²¹⁷ would fall within this category, and perhaps a reversionary interest,²¹⁸ though less probably, a power to direct that the income be "held or accumulated for future distribution to" him.²¹⁹ Powers of administration²²⁰ or of controlling beneficial enjoyment²²¹ would clearly seem not to be the equivalent of the power to "vest the corpus or the income" in himself, even though he has important powers which substantially give control of the benefits of the funds albeit for others than himself. Of course, although those powers might not affect him under section 678(a) (1), they might result in taxing trust income to him if he had renounced larger powers "to vest corpus or income" in himself and still retained the lesser powers of "control" under section 678(a) (2). This raises the further question whether any or all of such powers can be retained by the non-grantor party provided they are not exercisable "solely by himself" but only in conjunction with another person, such as a trustee. Since nothing is said in section 678(a) (1) about an "adverse party," it would seem, on the bare statutory language, that a trustee's consent would be enough to insulate the third party from tax liability. If this is so, it would follow that an insurance trust could be established with very broad

217. Cf. INT. REV. CODE OF 1954, § 676.

218. Cf. INT. REV. CODE OF 1954, § 673.

219. Cf. INT. REV. CODE OF 1954, § 677(a) (2).

220. Cf. INT. REV. CODE OF 1954, § 675.

221. Cf. INT. REV. CODE OF 1954, § 674.

powers left to the beneficiary—powers which, if possessed by the grantor, would inevitably result in personal taxation to him of trust income—and yet the beneficiary would not be subject to section 678 taxation if exercise of these powers required the prior consent of a trustee.

3. No significant section 678 question seems to be presented in another type of trust already discussed. That is the arrangement typified by H funding a trust of policies on W's life with their children designated as beneficiaries. H is not taxed under section 677(a) (3); W is likewise not taxed under section 677(a) (2)—her most likely point of exposure—since she is not the beneficiary. Even if it is arguable that the accumulation of income through insurance for the children is such that if it were being done for the trust grantor it would subject him to section 677(a) (2) taxation, it is clear that section 678 could not switch the income tax to the children since they never had a section 678 (a) (1) power "exercisable solely" by them to vest trust corpus or income, and if they have a lesser degree of "control" under section 678(a) (2) it is not the residue of a renunciation of the broader power. The trust income is therefore taxed to the trustee at the trust's low rates.

4. One case decided under section 22 of the 1939 Code should be noted. In *Alfred Cowles*²²² the grantor established a trust the income from which should be paid to his son, the taxpayer, "if he demands it," the unpaid income to be added to the trust principal, and the entire trust estate to be appointed by the son by will. The son was one of the trustees, the other being his brother. The trust indenture empowered the trustees to take out life insurance for the son, and in the taxable year trust income was used for a \$60,000 policy. The Tax Court held that under the *Mallinckrodt* doctrine, section 22 of the 1939 Code required that the son be taxed upon the trust income used for insurance on his life. The court noted²²³ that as to the income so applied, it was "within [the son's] power . . . as one of the two trustees to have blocked the taking out of such a policy and to have taken all of the net income for himself."²²⁴

222. 6 T. C. 14 (1946).

223. *Id.* at 21.

224. The *Mallinckrodt* concept was also applied in *Ralph W. Conant*, 7 T. C. 453 (1946), to an insurance trust. Here the grantor funded four insurance trusts with his wife as beneficiary, but gave his wife a power to revoke and take the corpus and undistributed income (*id.* at 456) as

It would seem that on these facts the same result would follow today under the 1954 Code. First, there is no section 677(a) (3) basis for attacking the grantor, since the policies are not on his life. Second, the income beneficiary has such a cluster of powers that they would be sufficient to tax him under the general rule of section 678(a). As we shall now show, the fact that trust income is or may be applied to insurance on the life of this "person other than the grantor" is of no consequence in reaching this result.

Varying the *Cowles*' facts, suppose the father establishes a trust in which he retains no rights or interests which could subject him to tax under section 671-677. As in *Cowles*, the trustee may take out insurance on the life of the income beneficiary, and does so. With only this potential benefit to him, clearly section 678(a) (1) does not make the son liable because the trust income may, without his intervention, be used for premiums on his life, or is in fact used. Moreover, it would seem that if he and another person were jointly empowered to decide whether to apply trust income to his life policies in trust, he would not be liable, for his power is now no longer "exercisable solely by himself," since the correlative power to "vest . . . the income therefrom in himself" requires the other person's consent also.

The only possibly relevant provision would be section 678 (a) (2), that the son has "such control as would . . . subject a grantor" to taxation under section 677(a) (3). As noted, however, this would ignore the fact that "such control" is relevant only if it exists as a residue after the "person other than the grantor" has "previously partially released or otherwise modified" the broader powers defined by section 678 (a) (1). By hypothesis, he had no such power; and thus he does not have the requisite "control" even though the trust income goes to his own life policies.

well as rights to receive or renounce current income (*id.* at 455). The Court noted that even here the income used on the policies "might be taxable to the grantor under the literal provisions of section 167(a) (3)" but thought that this was overridden by the fact of the wife's "powers, dominion, and control over the trust corpus." Hence, "the payments of premiums on policies of insurance on [the taxpayer's] life made from this income at the direction of his wife must be considered for tax purposes, as if made by his wife from her own income. Under this construction, these payments can not be considered as constituting income taxable to [taxpayer] under section 167(a) (3)" (*id.* at 462-63). The same result would follow today under § 678(a) (1) because of the wife's sole power to vest corpus in herself.

It is obvious, then, that the limited provisions of section 678 do not mean that a "person other than the grantor" will always be taxed with respect to some power or right just because the grantor would be taxed if he had that particular right or power. It is conjecture whether judicial development of the *Mallinckrodt* doctrine would have tended in that direction so that there would eventually have developed a strict one-to-one correspondence between the *Clifford* and *Mallinckrodt* rules on all matters to which they would be relevant. Clearly, section 678 does not do that. As a consequence, it opens up interesting avenues for estate planning with insurance trusts having a minimal tax impact. The instances discussed above are only illustrative.

C. *Taxation of Trust Income to Grantor or Other Person Under Section 61: The Limits of Section 671.*

Finally, although we have already observed it in passing, we should briefly note from a different perspective section 671. The intended effect of this section is to arrest the possibilities of further judicial development within the grantor or controlled trust area along the lines marked out first by *Clifford* and then by the *Mallinckrodt* cases, both interpreting section 22(a), now section 61 of the 1954 Code. These sections, it will be recalled, contain the general definition of "income." Section 671 now provides that

No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person *solely* on the ground of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart [*i.e.*, in subpart E comprising sections 671-678 inclusive].²²⁵

Apart from the fact that both *Clifford* and *Mallinckrodt* trusts are now subject only to the provisions of sections 671-678, the effect of the section has its limits. On its face it forecloses recourse to section 61 only if the taxpayer's "dominion and control" of the trust is the sole and exclusive basis for such taxation to him personally, but actually it permits the Commissioner to go outside of sections 671-678 when he can assert taxation upon grounds other than "dominion and control" of

225. INT. REV. CODE OF 1954, § 671 (emphasis and brackets added).

the trust, or perhaps even upon such control coupled with other grounds.

It is enough to note, as the Regulations do, the typical and likely situations where section 671 will not immunize the grantor or other person from personal taxation upon the trust income.²²⁶ Broadly speaking, the rules relating to the anticipatory assignment of income still remain applicable. For example, if an insured creates an unfunded trust of policies on his own life and makes an assignment of his future income to the trustee to pay the premiums, the grantor is clearly subject to tax.²²⁷ The same result would follow if, in our example, the taxpayer assigns to the trustee for premium-payment purposes accrued, but unpaid, income, or property in which accrued income is inherent, as in the leading decision of *Helvering v. Horst*.²²⁸ Presumably, the insurance trust grantor remains subject to tax in case he attempts to assign income derived from sources other than person services or property, *e.g.*, damages recompensing a legal injury.²²⁹

Undoubtedly, the taxpayer would be exposed to the same personal tax liability even though the purpose for which he assigns income is to support insurance on the life of some person other than himself. Although there seems little difference in actual effect between such an assignment and the admittedly tax-immune procedure of funding a trust of someone else's insurance, it is likely that the law's stout barriers against income assignment to reduce taxes would nevertheless prevail, and the taxpayer would be compelled to fund the trust through an outright conveyance of securities or the like. Finally, we call attention to the relation of insurance trusts and attempted tax savings through income shifting within family partnerships and family corporations, but this substantially separate area of tax law will not be further discussed here.²³⁰

These familiar principles thus illustrate an important point, that under section 671 the possibilities of taxation to the sub-

226. See Treas. Reg. § 1.671-1(c).

227. Cf. *Lucas v. Earl*, 281 U. S. 111 (1930). See also *Burnet v. Leininger*, 285 U. S. 136 (1932) (where the taxpayer unsuccessfully sought to make his wife "an equal partner" for tax purposes in his one-half partnership interest).

228. 311 U. S. 112 (1940).

229. Cf. *Doyle v. Commissioner*, 146 F. 2d 769 (4th Cir. 1945).

230. Noted in Treas. Reg. § 1.671-1(c).

stantial owner are not exclusively delimited by sections 671-678. Although the occasions are likely to be few, they may arise from other code sections, or from judicial doctrines not precisely or at all codified.

VII. CONCLUSION

As we noted at the outset, the insurance trust is a useful and flexible instrument for estate and business planning, and its utility will likely grow with the increasing use of life insurance.²³¹ Despite limitations imposed by the relevant statutes and other limitations developed by the courts, the insurance trust frequently offers itself as a satisfactory device for reducing income taxes. However, these limiting factors do govern broad areas, and the quest for income tax saving must accordingly be balanced against the elements of control and direction which must be surrendered. Thus, the insurance trust field is an excellent illustration of the interplay of areas of the law which too often are compartmentalized. The thoughtful and informed attorney recognizes these points of intersection and carefully evaluates his client's interests and needs. No less is to be expected of informed counsel.

Yet, knowledge and information alone are insufficient. Maximum effectiveness of a particular use of the insurance trust largely depends upon the meticulous choice of precise language, for in well drafted legal instruments as in poetry "[e]very phrase and every sentence is an end and a beginning."²³² Indeed, as we have already seen, a substantial number of the insurance trust tax cases have turned upon the language of the trust instrument.²³³ Thus, it is not enough for the attorney to know what is wanted; he must also know how to achieve what is wanted. In short, by combining knowledge of the subject with astute draftsmanship, the practitioner can, in many instances, utilize to his client's advantage,

231. See Part I, *supra*.

232. T. S. ELIOT, *Little Gidding*, V, in *FOUR QUARTETS* at 38 (1943).

233. See, *e.g.*, notes 81, 83, 88, 97, 147, 176-78, and 179 *supra*.

the significant tax-saving possibilities still inherent in the insurance trust.²³⁴

234. In conclusion, we point to the proposed Trust and Partnership Income Tax Revision Bill of 1960 (H. REP. NO. 9662), already discussed on another point at note 94a *supra*. This bill would add to present § 677 a provision declaring that "discretion exists . . . (2) to apply income to the payment of premiums on policies of insurance on the life of the grantor . . . even though the terms of the trust specify that the discretion relates only to corpus, to the extent that the income of the trust is not required to be distributed currently." H. REP. NO. 9662, 86th Cong., 2d Sess. § 177(b). The committees give the following example of the application of this proposed provision: "A establishes a trust and gives the trustee discretion to pay out the income to his son S or to accumulate it. A reserves the power to withdraw \$5,000 of corpus each year. The ordinary income of the trust exceeds \$5,000. A will be treated as the owner of \$5,000 of ordinary income, whether the income is paid to S or not, and whether A makes a withdrawal or not." H. REP. NO. 1231, 86th Cong., 2d Sess. 62-63 (1960); S. REP. NO. 1616, 86th Cong., 2d Sess. 67 (1960). Final Report, Advisory Committee on Subchapter J at 59. The same result would probably follow if we substitute for the withdrawal right in the example a provision that the trustee should annually pay up to \$5,000 from corpus on A's insurance premiums.